Approved 3/18/85
Date

MINUTES OF THE House COMMITTEE ON Judiciary.

The meeting was called to order by Representative Joe Knopp at
Chairperson

3:30 ~~a.m.~~/p.m. on March 4, 1985 in room 526-S of the Capitol.

All members were present except:

Representative Teagarden was excused.

Committee staff present:

Jerry Donaldson, Legislative Research Department
Mike Heim, Legislative Research Department
Mary Ann Torrence, Revisor of Statutes Office
Becca Conrad, Secretary

Conferees appearing before the committee:

Louis F. Eisenbarth, Attorney
Karen McClain, Kansas Association of Realtors
Bill Mitchell, Kansas Land Title
Representative Ken Francisco
Ron Griffin, Law Professor, Washburn University
Vern Jarboe, Spoke on behalf of Mid-America Lumber Association
Herb Whitlow, Kansas Plumbing, Heating and Cooling Contractors Association

HB 2494 - Concerning real property; relating to certain liens.

Louis F. Eisenbarth, a Topeka attorney, spoke in favor of this bill. His testimony is shown in Attachment No. 1. He said the consumer is in the least favorable position to protect himself against the dangers of losing his home by reason of having fully paid a contractor and still having liens up to the total price of the construction being filed on his house.

Karen McClain, Kansas Association of Realtors, spoke in favor of this bill as shown in Attachment No. 2. She said the problem which home buyers are facing is a battle of the unknown. They can't protect themselves from the filing of certain liens because they do not know the liens will be filed until it is too late.

Bill Mitchell, Kansas Land Title, also spoke favorably about HB 2494. He said that generally abstractors do everything they can to protect the parties either through title insurance or securing affidavits of unpaid bills. Even though those are secured, sometimes they get into very violent situations with respect to unpaid bills which throws them into controversy for a long period of time. He said they felt this bill would be a step forward in solving this problem.

HB 2296 - Concerning certain liens on real property; requiring certain warning statements; prohibiting certain acts by contractors and providing penalties for violations.

Representative Francisco presented two provisions to this bill which are shown in Attachment No. 3. The first provision relates to the matter of who has a right to warning statements and protection from liens filed against their home for materials used in construction where the money has already been paid to the primary contractor. The second provision is to provide the property owners with additional protection against the increasing problem of double liability.

Ron Griffin, Law Professor at Washburn University, spoke in favor of HB 2296. The following are virtues of the bill: 1.) it makes homeowners the secondary target; 2.) it focuses attention on the person who has breached the contract; 3.) it insulates funds against claims of the federal government under federal tax lien situations and insulates said funds against claims by a trustee in a bankruptcy proceeding under the bankruptcy act; 4.) it provides subcontractors with an opportunity to trace funds; and 5.) provides subcontractors with legislative protection of their own assets.

Vern Jarboe, President of Whelan's Lumber Company, spoke on behalf of Mid-America Lumber Association in opposition to HB 2494. He said this bill eliminates their right to file a lien unless it is filed before title of property has passed to a new owner. He said they may not always know of a change of ownership and therefore would not have an opportunity to file a lien. Mr. Jarboe said this bill is intended to assure a person purchasing a new home that he has no obligation for debts to the prior owner, but it also effects the rights of the supplier on property that is being approved and they have no way to know when that title passes. He said they do not believe it is necessary to negate the right to file a lien when the property changes hands. In most cases a lender, a title company, a real estate company or agent are involved. He said all are knowledgable people and could be expected to notify the purchaser that she or he should be sure all bills are paid before the purchase is completed.

Herb Whitlow, Kansas Plumbing, Heating and Cooling Contractors Association, spoke in opposition to HB 2494. He said they do not feel it is any improvement over the current laws we now have. Concerning HB 2296, they opposed this because the State of Kansas does not have a firm license law and anybody who wants to become a contractor becomes a contractor. He said he did not think the trust funds would work unless combined with a good, strong, state licensing code law.

HB 2050 - Concerning care and treatment of mentally ill persons.

Representative Duncan said some compromise language had been submitted since the last meeting on this. He said the SRS expressed concern about the definition of "severe mental illness". They suggested the following definition replace the one on page 4, section (o), of Attachment No. 4: "Severe mental disorder means a clinically significant behavioral or psychological syndrome pattern associated with either a painful symptom or serious impairment in one or more important areas of functioning and involving substantial behavior, psychological or biological disfunction". He also said the sentence about excluding chemical substances starting on line 139 - 142 should stay. Representative Duncan made a motion to substitute the definition of "severe mental disorder" as just stated. Representative Solbach seconded the motion and it carried.

Representative Duncan said that Charles Andrews made three suggestions for K.S.A. 59-2092, section (g), as shown in Attachment No. 5. Representative Duncan made a motion to adopt the amendments on page 2, line 64, of Attachment No. 4 with the deletion of damage to another's property as one of the standards. Representative Solbach seconded it.

Representative Bideau made a substitute motion to amend it as stated, leaving in "substantial damage to another's property". The reason for this is that it has been fairly strongly considered in the past along with "harming themselves or other". He said also it tracks this definition over to the criminal code of "not guilty by reasons of insanity" which would totally eliminate any considerations for substantial damage to property.

Representative Duncan stated that this was a contrary motion, the exact opposite of his motion. The Chairman ruled that to delete the entire seciton would be exactly opposite but to say that Representative Bideau's motion is the same as Representative Duncan's with one minor variation is not a contrary motion.

Representative Bideau's motion to adopt section (g) on page 2 of Attachment No. 4 in its current form was seconded by Representative Douville. The motion carried.

Representative Duncan made a motion that "except for reasons of indigency" be added in section (c), line 151 - 155 of page 46. Representative Solbach seconded it and the motion carried.

Representative Duncan made a motion to include "a licensed social worker" on the list in paragraph 6, line 82, page 15 of Attachment No. 4. It was seconded by Representative O'Neal and the motion carried.

Representative Duncan presented a suggestion by Mr. Albott, paragraph three of Attachment No. 6, concerning "Head of the treatment facility" being redefined. There was no motion.

Representative Duncan made a motion to strike "guidance counseling" in lines 390 - 391 and 398 - 399 and insert "or psychological" as shown in Attachment No. 6 of Mr. Albott. Representative Solbach seconded it and the motion carried.

Mr. Albott made another suggestion as shown in Attachment No. 6 to insert after medical officer the phrase "or treatment facility" on page 40, line 436 of Attachment No. 4. Representative Duncan made this motion and it was seconded by Representative Solbach. The motion carried.

Representative Duncan made a motion to delete the words "the hospital, clinic" and insert the words "a treatment facility, a" in New Section 37, typed page -3-, line 3 of Attachment No. 4 (stated in Attachment No. 6 of Mr. Albott). Representative Solbach seconded the motion and it carried.

The suggestion of Mr. Albott's concerning page 31 of the New Section (e), shown in Attachment No. 6, was presented. Representative Duncan disagreed with this because he said that it would remove administrative flexibility from the person who is designated and provides a structure where the head of a facility could not necessarily manage the treatment programs in the facility. There was no motion.

Representative Shriver made a motion to table HB 2050 to be referred to an interim committee. Representative Whiteman supported this motion because she felt that the changes were substantial enough that they needed to take a closer look at the definition section plus section 18 of the bill. She said they did not have adequate time to go through this and carefully consider the changes that the new definitions will have. Representative Solbach said they should adopt the subcommittee report and then move to refer it to an interim committee. Representative Shriver said he would agree to adopt the subcommittee report and then send to an interim committee. Therefore he withdrew his motion to table.

Concerning page 31 of the New Section (e) of Attachment No. 4, it was suggested that "outpatient" replace "another".

Mr. Albott made another suggestion on page 49, line 240 of Attachment No. 4, to strike the words "to psychosurgery" and add a New Section (8) "to consent, on behalf of a ward, to psychosurgery" as shown on page 2 of Attachment No. 6. Representative Duncan made this motion but withdrew it.

Representative Duncan made a motion to adopt the subcommittee report with the corrected version that Ms. Torrence has. Representative Solbach seconded the motion and it carried.

Representative Shriver made a motion to table substitute HB 2050 and send it to interim study. Representative Duncan opposed this motion because he said it is a workable bill, and if sent to an interim committee it will delay the ability to help persons needing involuntary treatment by at least two years. There was further discussion of this motion and upon a vote, it did not carry.

Representative Duncan made a motion to report substitute HB 2050 favorable to the House floor for action and it was seconded by Representative Douville. The motion carried.

HB 2049 - Concerning state institutions for the mentally retarded.

HB 2053 - Concerning mentally ill persons; relating to transfers and discharges thereof.

Representative Duncan made a motion to report HB 2049 for recommendation to be passed and HB 2053 to not be passed. Representative Solbach seconded and it carried.

HB 2065 - Concerning state institutions for the mentally retarded; relating to confidentiality of records.

Representative Duncan made a motion to adopt the amendments to HB 2065 and it was seconded by Representative Solbach. The motion carried. (See Attachment No. 7).

A motion was made by Representative Duncan to report HB 2065 favorably and it was seconded by Representative Solbach. The motion carried.

MINUTES OF THE House COMMITTEE ON Judiciary,

room 526-S, Statehouse, at 3:30 ~~a.m.~~/p.m. on March 4, 1985.

HB 2443 - Providing for licensure and regulation of certain transient merchants; prohibiting certain acts and providing penalties for violations.

Representative Vancrum made a motion to amend line 30 of HB 2443 to read "six months" instead of "less than six months". It was seconded by Representative Douville and carried.

A motion was made by Representative O'Neal that state and county fairs specifically be included in page 2, section j, as an exclusion. Representative Douville seconded it and it carried.

Representative Wunsch pointed out that the League of Municipalities had an amendment to protect their city ordinances on transient dealers. Representative Duncan made a motion to adopt this amendment and it was seconded by Representative Whiteman. It carried.

Representative Cloud made a motion to include sea food products in line 50, page 2. It was seconded by Representative Whiteman, but did not carry by a vote of nine to five. Representative Solbach said that sea food may be considered an agricultural product.

Representative Bideau made a substitute amendment to exempt agricultural products raised or produced by the seller. It was seconded by Representative O'Neal and carried by a vote of eleven to seven.

Representative Buehler made a motion to pass HB 2443 favorably as amended. It was seconded by Representative Teagarden and carried.

The meeting adjourned at 5:30 p.m.

TESTIMONY OF LOUIS F. EISENBARTH

As an attorney with thirty years experience I have represented builders, suppliers, financial institutions, owners, and title insurance underwriters with respect to the problems they confront in dealing with filing and litigating and the affect of Mechanic's Liens under existing Kansas law. I was an adjunct professor at Washburn Law School for several years teaching creditor's rights. The most difficult part of the law is that dealing with the liens of so-called subcontractors.

Under our present lien law as it pertains to subcontractors (K.S.A. 60-1103), a supplier of "labor, equipment, materials or supplies used or consumed at the site" under agreement with the contractor, may obtain a lien on the property by filing a verified statement containing certain information within three months after the last date any of the same was furnished, with the office of the Register of Deeds in the county where the property is located.

The significance of the statutory provision is that the LIEN ATTACHES THE PROPERTY RETROACTIVELY TO THE DATE THE ITEM WAS FIRST FURNISHED.

The statute provides protection for limited situations where the owner of a "pre-existing structure" in which he "resides" at the time any of the items are first furnished which is not used or intended to be used as a residence for more than two families or for commercial purposes.

Attachment No. 1
House Judiciary
March 4, 1985

The problem area is with those structures that are already under construction at the time the homeowner/consumer purchases the unit or those on which construction has been completed within the last three months prior to the closing of the transaction where the consumer acquires the unit.

It has been my experience that the consumer is in the least favorable position to protect himself against the dangers of losing his home by reason of having fully paid a contractor and still having liens up to the total price of the construction being filed on his house. The reason the consumer is in the least best position to protect himself is because when you compare him to the subcontractors, developers, builders and suppliers, he fails to compare favorably with them in the following areas:

A. Inexperience - Builders, subcontractors and suppliers are dealing with the construction business every day and are in a position to know the territory. The consumer doesn't buy many homes in a lifetime and therefore has no experience either with the law or with the customs of the industry.

B. Lack of Knowledge - Lien laws are intricate and sophisticated. Builders and suppliers generally know their lien rights. Consumers do not know those rights.

C. Difficulty in Ascertaining the Facts - It is difficult for the consumer to identify who the suppliers are. Contractors, particularly those in financial difficulty, skip around with suppliers and you may have three or four suppliers of lumber, for example, for a particular unit. In this modern day, there are a much larger variety of suppliers then there were fifty years ago insofar as a particular residential construction is

concerned. Whereas fifty years ago the contractor did most of the work himself, including the foundation and carpentry, he may have used a plumber, an electrician (outside of the carpenter, they were probably the only other two skilled people) or stone-mason. And the suppliers were generally two or three in number being a lumberyard and a plumbing supply and electric supply place and maybe a supplier of stone or brick.

Today we have suppliers of overhead doors for garages, suppliers of central vacuum systems, suppliers of windows, suppliers of roofing, suppliers of carpeting, suppliers of wallpaper, painters, drywall contractors, finish carpenters, rough-in carpenters, specialists in cement, specialists in excavating, specialists in landscaping, specialists in ground water systems, the furnishment of hardware fixtures, the furnishing of light fixtures, air conditioning, furnace, refrigerators, washers and dryers, ranges, dishwashers, guttering, and I have probably left a lot of them out.

Usually the consumer is confronted with a time limitation. Usually he is contractually obligated to vacate the place where he has been living and cannot obtain possession of the newly constructed place until he closes, so he is under pressure to close the transaction.

D. Difficulty in the consumer knowing about - overruns, extras.

E. Lack of availability of information on the financial status of the contractor - Suppliers to contractor generally are subcontractors who have dealt with the contractor in the

past, and many times they are carrying him an obligation on other projects, but they continue to supply him with the realization that if he doesn't pay them they can file a lien.

During this last year I have personally experienced the problems that a consumer experiences in buying a new house and I feel that I was probably in a better position than most consumers to protect myself because of my experience and knowledge of the lien laws. I purchased a townhouse that had just started to be constructed. I provided in my contract for the contractor to show me satisfactory proof of paid bills prior to closing. I sold my house in contemplation of giving me a few days grace to move into my townhouse. When the time approached for closing, my townhouse was completed and my contractor did not have all of his lien waivers and so I placed money in escrow in order to obtain possession. The money is to be released upon receipt of lien waivers. At the present time there are about 13 liens filed on my property, some of which the contractor contends are invalid because they were people that had been paid. Some of them are by suppliers who are suppliers I didn't know had furnished supplies to the house. Some of them are liens filed by contractors from whom I had lien waivers, some who contend they didn't sign the lien waivers and others who contend they did work subsequent to the signing of the lien waiver.

If I wanted to sell my townhouse today, I could not give good title without getting the liens adjudicated that are on my property.

Fortunately, I feel that I will not suffer an economic loss in the long run because of the money that I still have in escrow. There are a lot of people who have purchased townhouses in the area who don't have money in escrow. I found that some of the suppliers had overruns and costs over that estimated as to what the cost would be, some because of screw ups by the contractor in coordinating the work, others because of work that had to be done over because other subs had damaged the work that had been done. All of these things were things that I could not anticipate and was unable to ascertain by the investigation that I had made.

What I experienced goes on every day, and most consumers are not able to protect themselves.

From the standpoint of title insurance companies, they are reluctant to give lien coverage without additional premium and the only safe way for them to protect themselves is to monitor the funds from the purchase price and the only really safe way is to hold the money until the time for filing liens is expired. Few sellers, builders or developers can stand to have their money tied up ninety days; they need to turn their money into other projects.

The existing lien law no longer is adequate for the present market place.

We need to revise it to fit the contemporary marketplace.

TESTIMONY BEFORE

THE HOUSE JUDICIARY COMMITTEE

MARCH 4, 1985

BY

KAREN MCCLAIN

KANSAS ASSOCIATION OF REALTORS®

MR. CHAIRMAN AND MEMBERS OF THE HOUSE JUDICIARY COMMITTEE.

MY NAME IS KAREN MCCLAIN, DIRECTOR OF GOVERNMENTAL AFFAIRS FOR THE KANSAS ASSOCIATION OF REALTORS®.

I'D LIKE TO THANK YOU FOR THIS OPPORTUNITY TO SPEAK TO YOU TODAY. SENATE BILL 2494 ADDRESSES THE SERIOUS PROBLEM WHICH MR. EISENBARTH HAS LAID OUT FOR YOU. THE PROBLEM WHICH HOMEBUYERS ARE FACING IS A BATTLE OF THE UNKNOWN. THEY CAN'T PROTECT THEMSELVES FROM THE FILING OF THESE LIENS BECAUSE THEY DO NOT KNOW THE LIENS WILL BE FILED UNTIL IT IS TOO LATE.

THE PIECE OF LEGISLATION BEFORE YOU WAS DEVELOPED BY A VARIETY OF GROUPS WHO DEAL WITH THIS PROBLEM AS A MATTER OF BUSINESS AND WHO SAW THE URGENT NEED TO SEE THAT THE PROBLEM IS SOLVED, ONCE AND FOR ALL. THOSE GROUPS ARE: THE KANSAS ASSOCIATION OF REALTORS®, THE HOMEBUILDERS ASSOCIATION OF KANSAS, THE KANSAS LEAGUE OF SAVINGS INSTITUTIONS, AND THE KANSAS LAND TITLE ASSOCIATION.

SB 2494 PROVIDES THAT A LIEN MUST BE FILED BEFORE THE <u>EARLIER</u> OF TWO DATES, EITHER BEFORE TITLE PASSES OR, WITHIN THREE MONTHS OF THE DATE ON WHICH SUPPLIES, MATERIAL OR EQUIPMENT WAS LAST FURNISHED OR LABOR PERFORMED BY THE CLAIMANT.

THIS NEW LAW WOULD INSURE THAT, AT THE VERY LATEST, THE LIEN WOULD BE FILED AGAINST THE PROPERTY <u>PRIOR</u> TO THE TIME A HOMEBUYER TAKES TITLE TO THE PROPERTY, RATHER THAN THREE MONTHS AFTER A HOMEBUYER MOVES IN. THE PROPOSED LAW WOULD NOT

Attachment No. 2
House Judiciary
March 4, 1985

DENY THE RIGHT OF THE SUBCONTRACTOR TO FILE A LIEN IF HE HAS NOT BEEN PAID WHAT IS DUE HIM. IT WOULD ONLY REQUIRE THAT THE LIEN BE FILED UP FRONT, BEFORE THE TIME OF CLOSING SO THAT EVERYONE--THE TITLE COMPANY, THE LENDING INSTITUTION AND MOST IMPORTANT, THE HOMEBUYER KNOWS AT THE TIME THE DEED IS RECORDED WHO EXACTLY HAS RIGHTS AGAINST THE PROPERTY, SO THAT THE INNOCENT PURCHASER IS NOT HIT THREE MONTHS LATER WITH BILLS UNPAID BY THE BUILDER.

THERE WILL OBVIOUSLY BE OPPOSITION TO THIS CHANGE IN BUSINESS PRACTICE. THERE IS ALWAYS SOME SORT OF OPPOSITION TO CHANGE. TO SOME, IT MAY APPEAR THAT THIS PRACTICE OF REQUIRING SUBCONTRACTORS TO FILE THEIR LIEN UP FRONT, BEFORE CLOSING, IS A BURDENSOME REQUIREMENT. THEY MAY FEEL THAT THE AUTOMATIC FILING OF LIENS AGAINST PROPERTY MAY MAKE CONTRACTORS UPSET WITH SUBCONTRACTORS WHO FILE SUCH LIENS. I SUGGEST TO YOU THAT IF IT BECOMES THE BUSINESS PRACTICE OF ALL SUBCONTRACTORS TO FILE THESE LIENS IN THIS MANNER AND TO INSURE FOR THEMSELVES THAT THEY WILL BE PAID FOR THE WORK THEY HAVE DONE, CONTRACTORS CANNOT RETALIATE AGAINST ALL SUBCONTRACTORS. SUCH FILINGS WILL BECOME THE RULE RATHER THAN THE EXCEPTION. IS IT TOO MUCH TO ASK BUSINESS PERSONS TO ACT LIKE BUSINESS PERSONS, RATHER THAN PERMITTING THE CONSUMER TO PAY TWICE?

THERE HAVE BEEN QUESTIONS ASKED ABOUT THE SUBCONTRACTOR WHO HAS JUST BEGUN THE WORK ON THE HOUSE AND THEN THE PROPERTY TITLE PASSES BEFORE HE IS FINISHED. HOW CAN HE FILE A LIEN STATEMENT IF THE WORK IS NOT COMPLETED? IN ORDER TO ADEQUATELY PROTECT THAT SUBCONTRACTOR, I HAVE DRAFTED AN AMENDMENT TO THE BILL WHICH I BELIEVE WILL COVER THE SITUATION THAT AMENDMENT HAS BEEN ATTACHED TO MY TESTIMONY FOR YOU. THIS AMENDMENT WOULD PERMIT A SUBCONTRACTOR WHO HAS NOT COMPLETED HIS WORK TO STATE THIS IN HIS LIEN STATEMENT AT THE TIME OF FILING AND THEN, WHEN THE WORK IS COMPLETED, HE CAN FILE AN AMENDED STATEMENT FOR THE FULL AMOUNT AND THE FULL AMOUNT WILL HAVE THE SAME PRIORITY AS THE ORIGINAL STATEMENT. THIS AMENDMENT WILL PUT EVERYONE ON NOTICE THAT THIS SUBCONTRACTOR HAS DONE WORK ON THE PROPERTY AND IS ENTITLED TO LIEN RIGHTS, AND, AT THE SAME TIME, WILL COVER THE SUBCONTRACTOR FOR THE FULL AMOUNT WHICH IS DUE HIM.

PROPOSED AMENDMENT TO HB 2495

(3) If at the time of filing the lien statement, the contract is not completed, the lien statement shall state that fact, and any additional labor, equipment, material, or supplies furnished under the agreement shall be entitled to the same lien right and priority upon a subsequent filing of a statement of the amount due for the same.

HB 2296 - FIRST PART OF TESTIMONY - REPRESENTATIVE KEN FRANCISCO

THERE ARE TWO DIFFERENT PROVISIONS OF HB 2296 AMENDING K.S.A. 60-1103. THE FIRST PROVISION RELATES TO THE MATTER OF WHO HAS A RIGHT TO WARNING STATEMENTS AND PROTECTION FROM LIENS FILED AGAINST THEIR HOME FOR MATERIALS USED IN CONSTRUCTION WHERE THE MONEY HAS ALREADY BEEN PAID TO THE PRIMARY CONTRACTOR. THE CURRENT DEFINITION OF "RESIDENTIAL PROPERTY" refers to "A PRE-EXISTING STRUCTURE IN WHICH THE OWNER RESIDES AT THE TIME THE CLAIMANT FIRST FINISHES LABOR..." SINCE THIS DEFINITION HAS THE EFFECT OF EXCLUDING STRUCTURES THAT DID NOT EXIST OR STRUCTURES THAT WERE NOT BEING LIVED IN AT THE TIME THE CLAIMANT FIRST FURNISHES LABOR, MY AMENDMENT SIMPLY ADDS THE SAME PROTECTION FOR THESE HOMEOWNERS AS OUR PRESENT STATUTE PROVIDES TO RESIDENTIAL HOMEOWNERS WHO ARE BUILDING ADDITIONS ON THEIR HOMES. THAT IS, ALL OF THESE CLASSES OF INDIVIDUALS WILL HAVE THE RIGHT TO RECEIVE NOTICE AND WARNING STATEMENTS IN REGARDS TO LIENS FILED BY SUB-CONTRACTORS AGAINST THEIR HOME FOR MATERIALS USED IN CONSTRUCTION AND THE MONEY HAS ALREADY BEEN PAID OVER TO THE PRIMARY CONTRACTOR.

I'D PREFER TO RESPOND TO ANY QUESTIONS ON THIS PORTION OF MY AMENDMENT BEFORE PROCEEDING TO THE SECOND PORTION SINCE THE SECOND PORTION IS MORE COMPLEX.

Attachment No. 3
House Judiciary
March 4, 1985

STAN E. WISDOM, P.A.
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Wichita, Kansas 67202

STAN E. WISDOM
WILLIAM A. VICKERY
KENNETH M. NOHE
DOUGLAS J. KEELING

316/264-1012

31 January 1985

The Honorable Kenneth D. Francisco
House of Representatives
State Capitol
Topeka, Kansas 66612

Dear Ken:

I have dealt with a couple of cases in the last couple of months that have run me up against a real problem, both professionally and morally, in regard to the statutes on liens for labor and material concerning residential property.

K.S.A. 60-1103 was enacted not too long ago to provide some additional protection to homeowners with regard to work done by subcontractors. The section (and you might want to take a look at it) gives the residential homeowner the benefit of certain warning statements and protection from liens filed against their home for materials used in construction on it, where the money has already been paid over to the contractor.

The intent of this legislation, I am sure, was to provide additional protection for a residential homeowner with respect to liability for liens filed against their homes over the liability of a commercial builder who deals with contractors and sub-contractors in the regular course of their business.

The problem I have is in the definition provision of the section, which is subsection (e). Under this definition this section only applies to residential property which is a "pre-existing structure in which the owner resides at the time the claimant first furnishes labor..." The two cases I have been dealing with have been residential homeowners who have contracted with a general contractor to build them a new home on a lot which they have purchased. Because the definition under this section does not cover a structure that did not exist and was not being lived in prior to the time the contractor began work, these people were basically left out in the cold with respect to protection under this legislation.

There is no doubt in my mind that, as residential homeowners, they ought to be protected in the same way as a residential homeowner who builds an addition on to his house. I see no logic as to why they should be segregated out and treated differently.

I do see a potential problem arising where a commercial home-builder, who is building a whole development full of houses, might try to make use of this section, but I am sure there could be provisions included to preclude such a situation.

In short, if you build a $50,000 addition onto your house, you are protected by this statute, but if you build a brand new $50,000 house on a lot which you own, you are not. There is an inherent unfairness there.

While any future amendments will not help my clients who have been directly affected by this already, I would like you to see if there is anything you can do to propose a change that would effect more equitable treatment for residential homeowners under this statute.

If I can be of any assistance to you on this matter, please let me know.

Yours sincerely,

Douglas J. Keeling

DJK:t

P.S. Next time you are in town, give me a call and we will have lunch again. Thanks.

HB 2296 - SECOND PART OF TESTIMONY - REPRESENTATIVE FRANCISCO

THE PRIMARY PURPOSE OF THE SECOND PORTION OF MY BILL IS TO PROVIDE THE PROPERTY OWNERS WITH ADDITIONAL PROTECTION AGAINST THE INCREASING PROBLEM OF DOUBLE LIABILITY. AT PRESENT, OUR LAW ATTEMPTS TO PROVIDE PROTECTION FOR PRIMARY CONTRACTORS, SUB-CONTRACTORS AND PROPERTY OWNERS. IN REALITY, THE PROPERTY OWNER IS THE WEAKEST LINK IN THE CHAIN, IN THAT HE, THE OWNER, IS NOT IN A POSITION TO HAVE READY ACCESS OF INFORMATION RELATING TO FINANCIAL SITUATIONS OF CONTRACTORS - BOTH PRIMARY AND SUBS - NOR IS THE OWNER IN A POSITION TO HAVE READY ACCESS TO AGREEMENTS BETWEEN CONTRACTORS AND SUB-CONTRACTORS. THE OWNER'S POSITION IS FURTHER WEAKENED BY THE FACT THAT HIS LIFE IS AND SHOULD BE CENTERED AROUND HIS OCCUPATION AND HE IS UNABLE TO TAKE EXCESS TIME AWAY FROM HIS PRIMARY MEANS OF SUPPORT (HIS JOB) TO TRACE ALL FACTS THAT ARE LIKELY TO JEOPARDIZE HIS LIABILITY STATUS. THE OWNER'S POSITION IS FURTHER JEOPARDIZED BY THE FACT THAT IT IS HIS PROPERTY THAT IS THE SUBJECT MATTER OF THE PRESENT LIEN RIGHTS.

THE SECOND PORTION OF MY BILL IS ESSENTIALLY PROVIDING STATUTORY MEANS FOR INDIVIDUALS TO PROTECT THEIR PRESENT RIGHTS WHEN IT COMES TO DEALING WITH A "SCRUPULOUS" CONTRACTOR.

FIRST, MY PROPOSAL IDENTIFIES THE MONIES THAT ARE PAID TO A CONTRACTOR OR SUB-CONTRACTOR AS A "TRUST FUND". THE TERM "TRUST FUND" DOES NOT SET THIS MONEY ASIDE WITH ANY SPECIFIC TANGIBLE CHARACTERISTICS. WHAT IT DOES DO IS TO IDENTIFY THAT MONEY AS BELONGING TO THOSE INDIVIDUALS WHO HAVE A RIGHT TO BE PAID FOR CONTRACT WORK. THE "TRUST FUND" AS A LEGAL TERM OF ART WOULD HELP PREVENT THE CONTRACTOR AND SUB-CONTRACTOR FROM TAKING THE MONEY FOR

CIRCUMSTANCES UNRELATED TO THE PROPERTY OWNER AND SUB-CONTRACTORS' RIGHTS. SUB-CONTRACTORS WOULD MAINTAIN THE SAME RIGHTS AS THEY PRESENTLY HAVE, i.e. LIEN RIGHTS, CONTRACT RIGHTS - BUT WOULD ALSO HAVE AN IDENTIFIABLE SOURCE OF MONEY TO LOOK TOWARD FOR PAYMENT BEFORE THEY SUBJECT THE PROPERTY OWNER TO DOUBLE LIABILITY. LIKEWISE, THE PROPERTY OWNER CAN IDENTIFY THE "TRUST FUND" AS A RESOURCE FOR SUB-CONTRACTORS' PAYMENT BEFORE PAYING A SECOND TIME.

THE REMAINDER OF THIS SECTION IMPOSES PENALTIES OF CIVIL AND CRIMINAL LIABILITY TO HELP ELIMINATE UNSCRUPULOUS CONDUCT.

THE OVERALL EFFECT OF MY BILL IS NOT GOING TO BE A "FOOL PROOF" MECHANISM BUT IT IS A STEP TOWARD CORRECTING A PROBLEM WHICH SEEMS TO BE SUBSTANTIALLY INCREASING.

PUBLICATION OF THE
FORUM COMMITTEE
ON THE CONSTRUCTION
INDUSTRY

The Construction Lawyer

The Contractor in Bankruptcy— Protecting the Interests of the Owner

Robert L. Meyers III and Michael F. Albers†*

Robert L. Meyers III

Michael F. Albers

Introduction— The Owner's Goals and the Contractor's Bankruptcy

An owner's three primary concerns in any construction project are the quality of the work, the cost of performance, and the time required for completion. Consequently, the main goal of an attorney representing the owner is to protect the owner's interest in these areas. The bankruptcy of a general contractor and the problems associated therewith threaten each of these three primary concerns. A bankrupt contractor faces severe financial problems and cash shortages and therefore attempts to cut costs and corners, and as a result lowers the quality of the work. In order to increase revenues, the contractor seeks to raise the cost to the owner and to receive payment prior to performance, causing the owner to pay an inflated price for reduced quality. Detrimental as these actions may be, even more damaging to the owner's interest are the delays in performance and completion occasioned by the contractor's financial woes. The bankrupt contractor may not be able to afford necessary equipment, materials and personnel, and may lose essential subcontractors and suppliers due to his inability to make payments as they become due. This combination of calamities requires that every effort be taken from the very outset of the contractual relationship to protect the owner's interests in quality, cost, and time.

Successful representation and protection of the owner's interests is twofold. First, the contractual relationship between the owner and contractor must foresee the possibility of the contractor's insolvency and bankruptcy and deal with it properly. Second, the administration of the contract, both prior to petition of bankruptcy and thereafter, must be attentive, active, and when necessary aggressive, in order to preserve the owner's position and to avoid serious losses. The fundamental rule that one representing the owner must remember in both these areas is that the contractor's bankruptcy is not an isolated event, but rather the culmination of an ongoing problem which affects the entire construction process and everyone associated with it. Consequently, there are warning signs which the owner must notice and there are parties other than the contractor which the owner must deal with if the construction project is to be successful despite the general contractor's bankruptcy.

Drafting and Administering the Contract

The drafting of contractual provisions for the protection of the owner in the event of the contractor's bankruptcy requires that four broad areas be addressed. The contract must provide for (1) monitoring the contractor's progress, (2) evidencing timely payment to subcontractors and suppliers, (3) terminating the contractor for failure in performance of his obligations, and (4) continuing the progress of the work in the event of contractor's bankruptcy and/or termination. Failure to adequately deal with these matters at the outset of the contractual relationship will result in the owner incurring an unnecessary and improper allocation of risk, and can jeopardize the success of the construction project.

One of the better and more frequently employed forms of construction contract is prepared by the American Institute of Architects. Depending upon the basis of payment to the contractor, either AIA Document A101 (where the basis of payment is a stipulated sum) or AIA Document

(*continued on page 11*)

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Protecting the Interests

(*continued from page 1*)

A111 (where the basis of payment is the cost of the work plus a fee) may be used as the Owner-Contractor Agreement. In either case, the General Conditions of the Contract for Construction, AIA Document A201, are employed as well, and it is within these General Conditions that the matters referred to above are primarily addressed.

The AIA General Conditions provide for progress payments to the contractor based on applications for payment which are customarily submitted monthly. These applications for payment must be accompanied by information which supports the contractor's right to receive payment in the amount requested.

APPLICATIONS FOR PAYMENT

9.3.1 At least ten days before the date for each progress payment established in the Owner-Contractor Agreement, the Contractor shall submit to the Architect an itemized Application for Payment, notarized if required, supported by such data substantiating the Contractor's right to payment as the Owner or the Architect may require, and reflecting retainage, if any, as provided elsewhere in the Contract Documents.[1]

The General Conditions require that the contractor pay its subcontractors out of the funds received as progress payments. A contractor faced with serious financial difficulties and the prospect of bankruptcy will almost certainly attempt to delay payment to its subcontractors and suppliers in order to use such funds to relieve existing and past due debts. The cost of this practice to the owner is delay and possible abandonment of the work by dissatisfied subcontractors, and the filing of liens against the project by these parties. Therefore, the contract must impose an obligation on the contractor to promptly pay its subcontractors.

9.5.2 The Contractor shall promptly pay each Subcontractor, upon receipt of payment from the Owner, out of the amount paid to the Contractor on account of such Subcontractor's Work, the amount to which said Subcontractor is entitled, reflecting the percentage actually retained, if any, from payments to the Contractor on account of such Subcontractor's Work. The Contractor shall, by an appropriate agreement with each Subcontractor, require each Subcontractor to make payments to his Sub-subcontractors in similar manner.[2]

In the event of a material breach or default by the contractor, the owner must have the right to terminate the agreement. The owner additionally needs to have a mechanism by which it can terminate a bankrupt contractor should such prove necessary. As will be discussed subsequently, section 365 of the Bankruptcy Reform Act of 1978 severely limits the right to terminate an executory contract on account of bankruptcy, and prohibits the enforcement of "*ipso facto* clauses" which terminate executory contracts due to insolvency, petition for bankruptcy, or appointment of a trustee. Termination clauses have customarily employed such provisions, and the American Institute of Architects' form is no exception.

TERMINATION BY THE OWNER

14.2.1 If the Contractor is adjudged a bankrupt, or if he makes a general assignment for the benefit of his creditors, or if a receiver is appointed on account of his insolvency, or if he persistently or repeatedly refuses or fails, except in cases for which extension of time is provided, to supply enough properly skilled workmen or proper materials, or if he fails to make prompt payment to Subcontractors or for materials or labor, or persistently disregards laws, ordinances, rules, regulations or orders of any public authority having jurisdiction, or otherwise is guilty of a substantial violation of a provision of the Contract Documents, then the Owner, upon certification by the Architect that sufficient cause exists to justify such action, may, without prejudice to any right or remedy and after giving the Contractor and his surety, if any, seven days' written notice, terminate the employment of the Contractor and take possession of the site and of all materials, equipment, tools, construction equipment and machinery thereon owned by the Contractor and may finish the Work by whatever method he may deem expedient. In such case the Contractor shall not be entitled to receive any further payment until the work is finished.[3]

In the event that the contractor is terminated or is otherwise unable to fulfill its performance obligations, the contract must provide for completion by the owner or on its behalf. This right is essential to the owner in order to prevent extended delays, idle job time, added interest costs, and increased costs of materials and labor due to inflation.

OWNER'S RIGHT TO CARRY OUT THE WORK

3.4.1 If the Contractor defaults or neglects to carry out the Work in accordance with the Contract Documents and fails within seven days after receipt of written notice from the Owner to commence and continue correction of such default or neglect with diligence and promptness, the Owner may, after seven days following receipt by the Contractor of an additional written notice and without prejudice to any other remedy he may have, make good such deficiencies. In such case an appropriate Change Order shall be issued deducting from the payments then or thereafter due the Contractor the cost of correcting such deficiencies, including compensation for the Architect's additional services made necessary by such default, neglect or failure. Such action by the Owner and the amount charged to the Contractor are both subject to the prior approval of the Architect. If the payments then or thereafter due the Contractor are not sufficient to cover such amount, the Contractor shall pay the difference to the Owner.[4]

The protection afforded by the American Institute of Architects' provisions are crucial to the owner in the event of a contractor's bankruptcy. There are, however, additional contractual safeguards which owner's counsel should include in the Owner-Contractor Agreement to reduce the risk of loss to the owner. These additional provisions must assuredly favor the owner and not the contractor; they seek to extricate the owner and his project from the problems associated with the contractor's general business failure. This effort on the part of the owner represents an appropriate allocation of risk between the parties. Owner and contractor are bound by a contractual agreement entered into for a limited and specific business purpose; they are not partners. The owner should not have the success of his project jeopardized by the contractor's failures in performance and bankruptcy any more than the contractor should have his right to payment jeopardized by the owner's failure to

make a profit in other, unrelated activities.

One of the main problems associated with the contractor's bankruptcy is the failure of payment to subcontractors and suppliers and the resulting liens filed against the project. While this risk cannot be eliminated, it can be reduced. The Owner-Contractor Agreement should contain a procedure for verifying the contractor's payment practices, removing liens filed against the property, and recouping costs incurred by the owner in resolving such problems. The provision set forth below is one which I have employed to protect the owner's interests in these areas.

APPLICATIONS FOR PAYMENT

In each Request for Payment, Contractor shall certify that such Request for Payment represents a just estimate of cost reimbursable to Contractor under the terms of Section V(b) and shall also certify as follows:

"There are no known mechanics' or materialmen's liens outstanding at the date of this requisition, that all due and payable bills with respect to the Work have been paid to date or are included in the amount requested in the current application, and that, except for such bills not paid but so included, there is no known basis for the filing of any mechanics' or materialmen's liens on the Work, and that waivers from all subcontractors and materialmen have been obtained in such form as to constitute an effective waiver of lien under the laws of the situs of the project."

Contractor shall furnish with each Request for Payment waivers of lien for itself and each of its subcontractors and any other such forms as required by Owner or Owner's title insurer in order to assure an effective waiver of mechanics' or materialmen's liens in compliance with the law of the situs of the project.

"Contractor shall within fifteen (15) days after receipt of notice of the existence of any lien filed against the project by any subcontractor, supplier of materials or any other person or entity claiming to be a creditor of Contractor, cause the same to be removed as of record and/or bonded, at Contractor's sole cost and expense. Any payment due Contractor hereunder shall be reduced by an amount up to two hundred percent (200%) of the amount of any lien arising out of or related to Contractor's performance under this Agreement until such lien is removed as of record and/or bonded."

In addition to the above provisions, the owner may take advantage of state "trust fund" statutes to enforce the contractor's obligations to make payment. Pursuant to such statutes, all funds paid to the contractor are declared to be trust funds for the benefit of laborers, subcontractors and suppliers. For example, TEX. REV. CIV. STAT. ANN. § 5472e (1967) provides that a contractor who fails to pay its subcontractor is personally liable under the Texas statute. *See also* N. Y. LIEN LAW, art. 3-A, § 70-79a. The contractor may additionally be subjected to criminal liability if there was an intent to defraud. *See* TEX. REV. CIV. STAT. ANN. § 5472e, § 2 (1967). To make full use of the trust fund statute, the owner may require that the contractor establish a separate trust bank account for the purpose of receiving funds from the owner and making payment to subcontractors and suppliers. The following is a provision which accomplishes this purpose:

PAYMENTS

All sums advanced to the Contractor pursuant to this Agreement shall be deemed trust funds and shall be used solely for the purpose of performance of the Work in accordance with the Drawings and Specifications. At Owner's option, Contractor shall establish a separate trust bank account which shall be utilized solely for the purpose of receiving payments for the Work and paying its subcontractors, suppliers, laborers and employees, including reimbursements to Contractor of its costs and fee, as may be appropriate.

The owner's need to preserve the success of his project may require the termination of the failing contractor. This is an extreme measure, and one which is taken only when absolutely necessary. It is not done merely because the contractor has performed the physical act of petitioning for protection under the Bankruptcy Reform Act or has somehow become a pariah due to its failure to successfully and profitably conduct its business. Rather, termination becomes necessary because of the problems which attend the contractor's bankruptcy. First and foremost, the owner cannot afford to have his project stagnated. Illustrative of the importance of time is the growing number of construction projects that are performed under some type of "fast track" or "phased construction" plan in order to reduce the overall time required for completion. The schedule, the budget, the leases of completed space are all based on timely performance. By the time the owner resorts to termination, the project is almost certainly already seriously delayed. The Owner-Contractor Agreement must therefore provide a means of terminating the contractor in order to avoid having the contractor's problems become the owner's problems.

The Bankruptcy Reform Act of 1978 section 365(e) provides that:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Subsection (e) of section 365 invalidates clauses which automatically terminate a contract in the event of bankruptcy. The objection raised against such provisions is that they hamper the rehabilitation efforts of the bankrupt debtor. *See* 2 COLLIER ON BANKRUPTCY, ¶ 365.06 (15th ed. 1980) citing House Report at 348 and Senate Report p. 59. As shown in AIA Document A201, article 14.2.1, these clauses are still frequently found in contracts despite the admonitions of the Bankruptcy Reform Act. While the provision may in some instances be stricken from the documents during negotiation or merely ignored, proper drafting of the Owner-Contractor Agreement, from the owner's perspective, requires the modification of the provision.

Although section 365(e) of the Bankruptcy Reform Act was held not to violate the Fifth Amendment of the United States Constitution in *In re Sapolin Paints, Inc.*, 2 C.B.C. 2d 854 (B. Ct., E.D.N.Y. 1980), there has been relatively little case law interpreting its meaning and delineating its scope. The language of section 365(e) states that termina-

tion may not occur "solely" because of a provision based upon the contractor's bankruptcy. As mentioned previously, bankruptcy is not an isolated event, but rather the culmination of an ongoing series of failures and problems besetting the contractor. Consequently, the termination clause should reflect this fact and base its remedy on the associated breaches and default. The following provision is one attempt to draft protections for the owner in light of section 365:

TERMINATION

It is recognized that if Contractor is adjudged a bankrupt, or makes a general assignment for the benefit of creditors, or if a receiver is appointed for the benefit of its creditors, or if a receiver is appointed on account of its insolvency, such could impair or frustrate Contractor's performance of this Agreement. Accordingly, it is agreed that upon the occurrence of any such event, Owner shall be entitled to request of Contractor or its successor in interest adequate assurance of future performance in accordance with the terms and conditions hereof. Failure to comply with such request within ten (10) days of delivery of the request shall entitle Owner to terminate this Agreement and to the accompanying rights set forth above. In all events pending receipt of adequate assurance of performance and actual performance in accordance therewith, Owner shall be entitled to proceed with the Work with its own forces or with other contractors on a time and material or other appropriate basis the cost of which will be backcharged against the Contract Sum hereof.

The intent of this provision is to tie the owner's right of termination to the failure of the contractor to provide owner with the adequate assurances of future performance to which owner is otherwise entitled under the Bankruptcy Reform Act. Although such a provision has not been subject to litigation and court decision, it is consistent with both the letter and the spirit of the Bankruptcy Reform Act.

The owner may, if applicable, employ the other termination provisions of the Owner-Contractor Agreement as the basis for terminating the contractor. The grounds set forth in such provisions are based on the performance failures of the contractor, and are remedies which exist irrespective of the contractor's bankruptcy. These provisions therefore do not run afoul of section 365(e). Furthermore, these rights of termination do not violate the prohibition against disguising *ipso facto* clauses as insecurity clauses set forth in *In re Farmer*, 4 C.B.C. 2d 1461 (B. Ct., M.D. Fla., 1981).

TERMINATION

If Contractor shall fail to commence the Work in accordance with the provisions of this Agreement or fail to diligently prosecute the Work to completion thereof in a diligent, efficient, timely, workmanlike, skillful and careful manner and in strict accordance with the provisions of the Contract Documents (including the Scheduled Completion Date and Interim Completion Dates), fail to use an adequate amount or quality of personnel or equipment to complete the Work without undue delay, fail to perform any of its obligations under the Contract Documents, or fail to make prompt payments to its subcontractors, materialmen or laborers, then Owner shall have the right, if Contractor shall not cure any such default after seven (7) days written notice thereof to (i) terminate this Agreement, (ii) take possession of and use all or any part of Contractor's materials, equipment, supplies, and other property of every kind used by Contractor in the performance of the Work and to use such property in the completion of the Work, or (iii) complete the Work in any manner it deems desirable, including engaging the services of other parties therefor. Any such act by Owner shall not be deemed a waiver of any other right or remedy of Owner. If after exercising any such remedy the cost to Owner of the performance of the balance of the Work is in excess of that part of the Guaranteed Maximum Cost which has not theretofore been paid to Contractor hereunder, Contractor shall be liable for and shall reimburse Owner for such excess.

Owner may, if Contractor neglects to prosecute the Work properly or to perform any provision of the Contract Documents, or does, or omits to do, anything whereby safety or proper construction may be endangered or whereby damage or injury may result to person or property, after three (3) days written notice to Contractor, without prejudice to any other remedy Owner may have, make good all work, material, omissions or deficiencies, and may deduct the cost therefor from the amount included in the Guaranteed Maximum Cost due or which may thereafter become due Contractor, but no action taken by Owner hereunder shall affect any of the other rights or remedies of Owner granted by this Agreement or by law or relieve Contractor from any consequences or liabilities arising from such acts or omissions.

Owner hereby reserves the right to terminate this Agreement without regard to fault or breach upon written notice to Contractor, effective immediately unless otherwise provided in said notice. In the event of such termination, Owner shall pay as the sole amount due to Contractor in connection with this project (i) sums due for Work performed to date including allowable profit and overhead (except retainage sums shall not be paid prior to thirty (30) days following the date of termination); (ii) reasonable cost of termination; and as additional and special consideration for this provision (iii) a profit for unperformed Work equal to five percent (5%) of the cost of the Work actually performed to date.

Upon a determination by a court that termination of Contractor or its successor in interest pursuant to any of the provisions of this Section was wrongful, such termination will be deemed converted to a termination for convenience as set forth above, and Contractor's remedy for wrongful termination is limited to the recovery of the payments permitted for such termination for convenience as set forth herein.

The Owner-Contractor Agreement must allow the owner to proceed with the performance of the work following the termination of the contractor. In this regard, two of the owner's main concerns are (1) keeping the existing subcontractors and suppliers on the job and bound by their existing prices, and (2) preserving the right to use existing materials. If the owner is unable to require those subcontractors and suppliers already engaged in the work to continue performance, the owner will lose valuable time in rebidding the work, and will be forced to pay additional start-up and related costs to the new parties. Similarly, if the owner does not have the right to make use of materials already acquired, he will have to pay the costs of repurchasing. Two provisions can be added to the Owner-Contractor Agreement which protect the owner's interests in these areas. The first of these two provisions in an assignment clause whereby the contractor presently assigns all subcontracts and purchase orders; however, the assignment is effective only upon owner's written acceptance of the specified subcontract(s) and or purchase order(s).

ASSIGNMENT

Contractor hereby assigns to Owner (and its assigns) all its interest in any subcontracts and purchase orders now existing or hereinafter entered into by Contractor for perfor-

mance of any part of the Work which assignment will be effective upon acceptance by Owner in writing and only as to those subcontracts and purchase orders which Owner designates in said writing. It is agreed and understood that Owner may accept said assignment at any time during the course of construction prior to final completion. It is further agreed that all subcontracts and purchase orders shall provide that they are freely assignable by Contractor to Owner and assigns. It is further agreed and understood that such assignment is part of the consideration to Owner for entering into this Agreement with Contractor and may not be withdrawn prior to final completion.

The second provision should clearly state when and upon what conditions title passes to the owner. Such a provision will minimize the risk of having materials and/or portions of the work treated as property of the bankrupt's estate under section 541 of the Bankruptcy Reform Act.

APPLICATIONS FOR PAYMENT

Applications for Payment shall include the value of materials or equipment not incorporated in the Work but delivered and suitably stored at the site or at some other location agreed upon in writing by the parties hereto. Title to all equipment and materials shall pass to Owner upon payment therefor or incorporation in the Work whichever shall first occur, and Contractor shall prepare and execute all documents necessary to effect and perfect such transfer of title.

TITLE OF WORK

Immediately upon the performance of any part of the Work, as between Contractor and Owner, title thereto shall vest in Owner; provided, however, the vesting of such title shall not impose any obligations on Owner or relieve Contractor of any of its obligations hereunder.

While it is essential that the Owner-Contractor Agreement establish the rights of the owner and properly allocate the risks related to the contractor's bankruptcy, these alone are worthless if the owner's interests are not vigilantly guarded during the construction phase. The owner and owner's onsite representatives must constantly monitor the progress of the work, and recognize the warning signs of impending trouble. This requires not only the careful evaluation of all application for payment, the regular inspection of the work, and the verification of actual payments to subcontractors and suppliers but also that there be an awareness to information in the business community concerning the contractor's performance on other jobs, payment practices, and general business stability. If problems exist, the owner must find out about them promptly so that he can enforce his rights; the owner cannot afford to be the last to know.

The administration of the Owner-Contractor Agreement following the contractor's petition for bankruptcy requires that special attention be given to certain provisions of the Bankruptcy Reform Act. The requirements and restraints of these provisions are important whether or not the owner has decided to terminate the contractor as they affect the right to make use of equipment and materials, to setoff claims against the contractor, and to proceed directly against the contractor to preserve or enforce the owner's claims. While the owner needs to proceed in compliance with the requirements of the Bankruptcy Reform Act, the key concern from the owner's perspective remains the continuation of the progress of the project to a successful completion.

The contractor's petition for bankruptcy operates as an automatic stay against efforts to enforce claims against the contractor pursuant to section 362(a) of the Bankruptcy Reform Act. This stay should not, however, prevent the continuation of the project or the termination of the contractor, provided such is not a violation of the provisions of section 365(e) of the Bankruptcy Act. The provisions of section 362(a) prohibit efforts to collect property of the estate or to set off debts owing the bankrupt which arose prior to the commencement of the case. *See* BANKRUPTCY REFORM ACT of 1978 § 362(a)(3) and § 362(a)(7). The diligent enforcement of owner's contractual rights concerning passage of title during the performance of the work will minimize the amount of materials, tools, equipment and completed work subject to ownership by the estate. With respect to rights of setoff, the constraints of section 362(a)(7) apply only to pre-petition debts and should not be applicable to those portions of the contract sum attributable to work not yet performed and for which payment is not yet due. Additionally, the Bankruptcy Reform Act preserves the right to setoff, except as expressly limited by specific sections therein. BANKRUPTCY REFORM ACT of 1978 § 553.

Just as the commencement of the case in bankruptcy operates as an automatic stay, the commencement also creates an estate composed of all legal or equitable interest of the debtor in property, wherever located, pursuant to section 541 of the Bankruptcy Reform Act. In order to avoid the effects of this provision, the owner must enforce his right under the Owner-Contractor Agreement with respect to ownership of materials and of the work. Failure to do so will result in the loss of materials and other property to the estate, at the expense and to the detriment of the owner. As previously discussed, the application of state trust fund statutes, such as TEX. REV. CIV. STAT. ANN. § 5472e (1967) and N. Y. LIEN LAW, article 3-A, §§ 70–79a, provides that monies paid to the contractor are declared to be trust funds for the benefit of laborers, subcontractors and suppliers. Although section 541 creates an estate composed of all legal or equitable interests of the debtor, funds paid to the contractor which are required to be held in trust for the benefit of third parties are arguably beyond the reach of the section, and may therefore be recovered and applied to the claims asserted by subcontractors and suppliers. In light of section 541, provisions contained in AIA Document A201, article 14.2.1, and in other construction contracts, which give the owner the right to "take possession of the site and all of the materials, equipment, tools, construction equipment and machinery thereon owned by Contractor" would appear to be unenforceable where the contractor has filed for bankruptcy.

An additional procedure which the owner may employ when faced with a bankrupt contractor is to make payment by checks issued jointly to the contractor and its subcontractors and/or suppliers. This method of payment may be requested by subcontractors and suppliers, and may be insisted upon by the owner when the contractor has consistently failed to make proper payments. The advantage to the owner is that the procedure ensures that the subcontractors and suppliers get paid and consequently keeps the

owner's property free of liens. Contractors strongly resist this method of payment as it reduces their ability to control the subcontractors and suppliers, and constricts the source of funds available for the contractor's use. Consequently, provisions giving owner this right do not frequently appear in the contract documents; however, the owner may decide to exercise his power to make payment in this manner despite the absence of the right to do so where the situation warrants such action. Owners can expect continued strong resistence to this form of payment in light of case law holding that payment by joint check does not constitute proper payment where endorsements cannot be obtained due to lack of cooperation between the payees. *Piedmont Engineering & Construction Corp. v. Amps Electric Co., Inc.*, 292 S.E.2d 411 (Ga. App.-1982).

Bonded Projects and the Owner's Rights

The foregoing discussion has assumed a situation wherein the contractor has not provided payment and performance bonds covering his work. In the event the contractor has been required to obtain such bonds, an extra measure of protection may be afforded to both the owner and to the contractor's subcontractors and suppliers. These bonds, whether payment or performance, are three party contracts between a surety, the contractor as principal on the bond, and the obligee—either the subcontractors and suppliers under the payment bond or the owner under the performance bond. The payment bond sets forth the surety's obligation to make payment to the subcontractors and suppliers, in an aggregate amount not to exceed the penal sum of the bond, should the contractor fail to do so. The performance bond requires the surety, to the extent of the penal sum of the bond, to see to the performance of the Owner-Contractor Agreement, either by arranging for completion of the work or by paying money directly to the owner.

In order to enforce a claim under the performance bond, the owner must first declare the contractor to be in default under the Owner-Contractor Agreement. If the contractor is not in default the surety has no obligation, since the condition of the bond is always such that if the contractor, as principal, shall faithfully perform its duties under the Owner-Contractor Agreement, the obligation under the bond is void. *See* AIA Document A311. Consequently, the contractor must be failing in its performance and in default for the owner to have any rights to the benefits of the performance bond.

Once the owner has demanded that the surety honor its obligation under the bond the surety has the right to raise defenses to the enforcement of the bond. Two types of defenses are available to the surety. First, the surety may assert any defense which the surety has either under the express terms of the bond or as a result of the conduct of the owner as the obligee, i.e., acts of fraud or misrepresentation in inducing the surety to execute the bond. In order to preserve the claim on the performance bond, the attorney for the owner must make sure that the owner strictly complies with the provisions and conditions set forth in the bond. Accordingly, the owner must bring any action on the bond within the time set forth therein, and must perform any conditions precedent to the surety's obligation of performance.

The second type of defenses available to the surety are those which the contractor has pursuant to the Owner-Contractor Agreement. The surety has the right to invoke those defenses available to its principal because the liability of the surety for the defaults of its principal, the contractor, can not exceed that of the principal. *State v. Massachusetts Bonding and Insurance Co.*, 117 P.2d 80 (Cal. App. 1941).

The surety's right to assert the contractor's defenses raises the issue of whether or not the surety can avoid its obligation on the bond by claiming improper termination of the contractor. Specifically, if the owner terminates the contractor due to its insolvency or bankruptcy, i.e., under an actual or disguised *ipso facto* clause, either the contractor as the debtor in possession, or the bankruptcy trustee, would contend that the termination was in violation of section 365(e) of the Bankruptcy Reform Act, and the surety would similarly claim the right to this defense. The owner should, therefore, make certain that the decision to terminate the contractor is based on a material breach of the Owner-Contractor Agreement which jeopardizes the success of the construction project, i.e., the contractor's failure to properly man the job, to meet the progress schedule, to pay subcontractors and suppliers, or other similar events of default. Absent such conduct and events the owner does not stand to gain by terminating the contractor, and can not expect the surety to honor the bond. If material breaches have occurred, the owner should be able to enforce its rights under the bond notwithstanding the bankruptcy of the Contractor or the automatic stay provisions of section 362 of the Bankruptcy Reform Act.

Conclusion

The bankruptcy of the general contractor has the potential to cripple the owner's plans for construction. Like all this, it is most damaging if it arrives unexpectedly and remains untreated. It is also contagious. While it would be rare for the contractor's bankruptcy to result in the owner's bankruptcy, the owner can fall victim to the contractor's financial plight and suffer extensive losses if the proper steps are not taken to protect the owner. Initially, the contractual relationship must provide the owner with the means to monitor the contractor's performance, practices, and stability, and also with the means to extricate himself from the contractor's difficulty. During the construction phase, the owner and its counsel must be attentive to the ongoing progress, and problems, in the work. If the situation is permitted to develop so that the first time the owner knows of the contractor's difficulties is the filing of the petition for bankruptcy, the owner is at the mercy of the contractor and the court, and the project's success is threatened. Above all else, the progress of the work, whether by the contractor or by other parties, must be maintained. Only in this

way can the owner's interests in quality, cost and time be protected and the success of the project preserved.

Footnotes

1. General Conditions of the Contract for Construction, AIA Document A201, 13th ed., Aug. 1976, art. 9.3.1.
2. General Conditions of the Contract for Construction, AIA Document A201, 13th ed., Aug. 1976, art. 9.5.2.
3. General Conditions of the Contract for Construction, AIA Document A201, 13th ed., Aug. 1976, art. 14.2.1.
4. General Conditions of the Contract for Construction, AIA Document A201, 13th ed., 1976, art. 3.4.1.

Program on "Trouble Areas in Construction" Set for January 24 in New York

The Forum Committee on the Construction Industry and the Fidelity and Surety Law Committee of the Section of Tort and Insurance Practice will cosponsor a one-day program entitled "Trouble Areas in Construction" at the Grand Hyatt Hotel in New York City on Thursday, January 24, 1985. Erwin L. Corwin of New York and S. Gordon Elkins of Philadelphia will co-chair the event. The following topics will be addressed:

- A Comparison of the AIA General Contractor Agreement with the New AGC Form 600 and its Effect on All Parties;
- Direct Payments from Owners to Subcontractors with Implications for Everyone Concerned;
- The Effect of IRS Liens and Levies on the Contractor, Owner and Surety;
- The New AIA Performance and Payment Bond Forms—What They Mean to the Surety, Owner and Contractor;
- Liability of Surety, Contractor and Subcontractor After Final Completion and Acceptance;
- An Introduction to Nuclear Plant Construction Problems, Both Finished and Unfinished Projects;
- The Relationships Between the Construction Lender and the Surety, Owner and Contractor;
- The Relationship of Principal, Subcontractor and Surety in Arbitration Proceedings.

Tuition has been set at $110 for members of the Forum Committee and members of the cosponsoring Fidelity and Surety Committee, $25 for law students, and $150 for all others.

Members of the Forum Committee will receive a detailed brochure in due course. Others may request information from Norman Nelson at ABA headquarters in Chicago.

Rights and Remedies

(*continued from page 6*)

tion 544(a) and thereby avoid any transaction which would be avoidable under applicable state law by a lien creditor, the right to avoid statutory liens (11 U.S.C. § 545), and the right to avoid preferences (11 U.S.C. § 547). The seller's reclamation right, however, is subject to avoidance by a trustee or debtor-in-possession under other avoiding powers in the code. For example, under section 544(b), the trustee or debtor-in-possession may clothe itself with the rights of any existing, unsecured creditor of the debtor on the date of filing. If any such creditor could avoid the reclamation petition under applicable state law, then the trustee would have a similar avoiding power.

Although the reclamation right of the unpaid subcontractor/materialman is in many respects limited by the Bankruptcy Code, in at least one respect, it may be expanded. Recall that the right of reclamation may be subject to the rights of a secured creditor who has a floating lien on after acquired property of the contractor. Section 552(a) of the Bankruptcy Code provides that property acquired by a debtor after commencement of the case will not be subject to a security interest of a financing bank, even if the security agreement contains an after acquired property clause. Thus, the subcontractor/materialman who delivers goods which are received after the filing may exercise its reclamation rights with respect to such after acquired property free of the otherwise superior rights of the financing bank having a lien on after acquired property.

Mechanics Lien Rights

Although this article deals primarily with the rights of subcontractors and materialmen upon the bankruptcy of the contractor, the subcontractor/materialman's rights and remedies as against the owner of the project cannot be ignored. A principle remedy is the mechanics lien. While state laws differ, most states allow a person who furnishes labor or material in the construction or improvement of real property to have a lien securing payment. There are usually technical rules for perfection of that lien, which may include the timely filing of a public notice and/or the timely filing of a lawsuit. While it would appear at first glance that the bankruptcy of the contractor would not adversely affect or impair the mechanics lien rights and remedies of the subcontractor/materialman as to the owner, reference must be made to section 362(a)(6) of the Bankruptcy Code, the automatic stay. That section prohibits the taking of any act "to collect, assess or recover a claim against the debtor that arose before commencement of the case under this title." Technically speaking, the filing of a mechanics lien claim or the commencement of a suit, even though an action against property of the owner, and not property of the contractor, could be construed as an act to

Wisconsin

a lien is claimed were furnished after that date is on the lien claimant.

(4) **Notice and filing requirements in s. 779.06 unaffected.** Nothing in this section shall be construed to relieve any lien claimant of the notice and filing requirements under s. 779.06.

(5) **Theft by contractors.** The proceeds of any mortgage on land paid to any prime contractor or any subcontractor for improvements upon the mortgaged premises, and all moneys paid to any prime contractor or subcontractor by any owner for improvements, constitute a trust fund only in the hands of the prime contractor or subcontractor to the amount of all claims due or to become due or owing from the prime contractor or subcontractor for labor and materials used for the improvements, until all the claims have been paid, and shall not be a trust fund in the hands of any other person. The use of any such moneys by any prime contractor or subcontractor for any other purpose until all claims, except those which are the subject of a bona fide dispute and then only to the extent of the amount actually in dispute, have been paid in full or proportionally in cases of a deficiency, is theft by the prime contractor or subcontractor of moneys so misappropriated and is punishable under s. 943.20. If the prime contractor or subcontractor is a corporation, such misappropriation also shall be deemed theft by any officers, directors or agents of the corporation responsible for the misappropriation. Any of such misappropriated moneys which have been received as salary, dividend, loan repayment, capital distribution or otherwise by any shareholder of the corporation not responsible for the misappropriation shall be a civil liability of the shareholder and may be recovered and restored to the trust fund specified in this subsection by action brought by any interested party for that purpose. Except as provided in this subsection, this section does not create a civil cause of action against any other person. Until all claims are paid in full, have matured by notice and filing or have expired, such proceeds and moneys shall not be subject to garnishment, execution, levy or attachment.

(6) **Prime contractors to defend lien actions.** When a lien is filed under this subchapter by any person other than the prime contractor, the prime contractor shall defend any action thereon at personal expense, and during the pendency of the action the owner may withhold from the prime contractor the amount for which the lien was filed and sufficient to defray the costs of the action. In case of judgment against the owner, the owner may deduct from any amount due to the prime contractor the amount of the judgment and if the judgment exceeds the amount due, the owner may recover the difference from the prime contractor.

(7) **Wrongful use of materials.** Any prime contractor or any subcontractor furnishing materials who purchases materials on credit and represents at the time of making the purchase that the materials are to be used in a designated building or other improvement and thereafter uses or causes them to be used in the construction of any improvement other than that designated, without the written consent of the seller, may be fined not more than $300 or imprisoned not more than 3 months.

(8) **Wage payments to laborer apply to earlier work.** In any situation where a laborer or mechanic employed by any prime contractor or subcontractor has wage payments due and has worked on more than one improvement for the employer during the period for which the wages are due, and a payment of less than all wages due is made, the payment is deemed to apply to the unpaid work in chronological sequence starting with the earliest unpaid time, unless the laborer agrees in writing that the payment shall be applied in a different way.

Legislative Council Note—1967

Proposed s. 289.02, includes much of the matter covered by present s. 289.02, but with substantial changes. Present s. 289.02(2), relating to filing of claim, is merged in proposed s. 289.06, and has been dropped. The first part of the section deals with notice requirements, first stating the exceptions to the notice requirements, then setting forth the requirements.

[As to (1)(a)] This exception simply states the present law, now found in s. 289.02(3).

[As to (1)(b)] Under present law, a "contractor" as now defined in s. 289.01(1)(a) is exempt from the notice requirements of s. 289.02. This exemption for certain types of prime contractors, such as architects and surveyors, would be continued in the proposed section. However, many prime contractors will have notice-giving responsibility under proposed s. 289.02(2)(a), to which the above section refers, and this represents a substantial change from present law.

[As to (1)(c)] This proposal represents a major change from present law. It eliminates any notice requirement (of the sort now found in s. 289.02) for other than relatively small construction. The purpose is to work toward earlier and more realistic notice on those smaller jobs where the owner may be inexperienced, unaware of the construction lien laws, and hence in possible danger of having to pay twice or lose his property. On larger construction, such unawareness will not be a factor, and lenders and owners can set up their own machinery for ascertaining who the potential lien claimants are.

diction.

(e) "Lacks capacity to make an informed decision concerning treatment" means that the person, by reason of the person's mental disorder or condition, is unable, despite conscientious efforts at explanation, to understand basically the nature and effects of hospitalization or treatment or is unable to engage in a rational decision-making process regarding hospitalization or treatment, as evidenced by inability to weigh the possible risks and benefits.

(f) "Law enforcement officer" means any sheriff, regularly employed deputy sheriff, state highway patrol officer, regularly employed city police officer or a law enforcement officer of any county law enforcement department.

(g) "Likely to cause harm to others" means, as evidenced by behavior causing, attempting or threatening harm to others, that the person is likely, in the reasonably foreseeable future, to cause physical injury or physical abuse to another person or substantial damage to another person's property.

(h) "Likely to cause harm to self or suffer substantial mental or physical deterioration" means that the person:

(1) Is likely, in the reasonably foreseeable future, to inflict substantial physical injury to the person's self;

(2) is substantially unable to provide for any of the person's basic needs, such as food, clothing, shelter, health or safety; or

(3) will, if not treated, suffer or continue to suffer severe and abnormal mental, emotional or physical distress causing a substantial deterioration of the person's ability to function on the person's own.

(a) (i) "Mentally ill person" means any person who is mentally impaired:

(1) Is suffering from a severe mental disorder to the extent that such person is in need of treatment and who is dangerous to self or others and:

(1) who lacks sufficient understanding or capacity to make responsible decisions with respect to the person's need for treatment; or

(2) who refuses to seek treatment. Proof of a person's failure

[(g) "Likely to cause harm to self or others" means that the person:

(1) Is likely, in the reasonably forseeable future, to cause physical injury or physical abuse to self or others or substantial damage to another's property, as evidenced by behavior causing, attempting or threatening such injury, abuse or damage

[, except for reason of indigency,

[is suffering

[(h)

Attachment No. 4
House Judiciary
March 4, 1985

~~to meet the person's basic physical needs, to the extent that the failure threatens such person's life, shall be deemed as proof that the person is dangerous to self, except that;~~

(2) lacks capacity to make an informed decision concerning treatment; and

(3) is likely to ~~(A)~~ cause harm to self or ~~suffer substantial mental or physical deterioration or (B) cause harm to~~ others.

No person who is being treated by prayer in the practice of the religion of any church which teaches reliance on spiritual means alone through prayer for healing shall be determined to be a mentally ill person unless substantial evidence is produced upon which the district court finds that the proposed patient is ~~dangerous to self or~~ *likely to cause harm to self, ~~suffer substantial mental or physical deterioration or cause harm to~~* others. [or [(i)

~~(b) (j)~~ "Patient" means a person who is ~~an informal patient~~, a voluntary patient, a proposed patient, or an involuntary patient.

~~(c) "Informal patient" means a person either receiving outpatient treatment at a treatment facility or who is admitted to a treatment facility pursuant to K.S.A. 59-2904.~~

~~(d) "Voluntary patient" means a person, other than an informal patient, who is receiving treatment at a treatment facility other than by order of any court.~~

~~(e) "Proposed patient" means a person for whom an application pursuant to K.S.A. 59-2913 has been filed.~~

~~(f) "Involuntary patient" means a mentally ill person who is receiving treatment under an order of a court of competent jurisdiction.~~

~~(g) "Treatment facility" means any mental health clinic, psychiatric unit of a medical care facility, adult care home, physician or any other institution or individual authorized or licensed by law to give treatment to any patient.~~ [(j)

~~(h) (k)~~ "Physician" means a person licensed to practice medicine and surgery as provided by the Kansas healing arts act or a person who is employed by a Kansas state hospital or by an agency of the United States and who is authorized by either government to practice medicine and surgery.

~~(i) "Head of the treatment facility" means the administrative~~

nesses. If the person ~~against~~ *with respect to* whom the application has been filed has not retained an attorney, the court shall appoint an attorney for ~~such~~ *the* person in the same manner as an attorney is appointed under the provisions of ~~subsection (c) of~~ K.S.A. 59-2914 *and amendments thereto*. All persons not necessary for the conduct of the proceedings may be excluded. The hearing shall be conducted in as informal a manner as may be consistent with orderly procedure and in a physical setting not likely to have a harmful effect on the person ~~against~~ *with respect to* whom the application has been filed. The court shall receive all relevant and material evidence which may be offered. *The rules governing evidentiary and procedural matters at hearings under this ~~act~~ shall be applied so as to facilitate informal, efficient presentation of all relevant, probative evidence and resolution of issues with due regard to the interests of all parties. Hearsay evidence may be received, and experts and other witnesses may testify to any relevant and probative facts at the discretion of the court.* If the applicant is not represented by counsel, the county or district attorney shall represent the applicant, prepare all necessary papers, appear at the hearing and present such evidence as ~~he or she shall determine~~ *the county or district attorney determines* to be of aid to the court in determining whether or not there is probable cause to believe that the person ~~against~~ *with respect to* whom the application has been filed is a mentally ill person ~~and is likely to do physical injury to himself or herself or others if not immediately detained~~.

If the court determines from the evidence that there is probable cause to believe that the person ~~against~~ *with respect to* whom the application has been filed is a mentally ill person ~~and is likely to do physical injury to himself or herself or others~~ if not immediately detained, the court shall issue an order of protective custody; otherwise, the court shall terminate the proceedings.

~~(g)~~ *(d)* The order of protective custody issued pursuant to provisions of this section may authorize a health officer, physician, ~~peace~~ *law enforcement* officer or other person to take the person ~~against~~ *with respect to* whom the application has been filed into custody and to transport and place ~~such~~ *the* person in a

[section

opportunity to appear at the hearing, to testify, and to present and cross-examine witnesses. All persons not necessary for the conduct of the proceedings may be excluded. The hearings shall be conducted in as informal a manner as may be consistent with orderly procedure and in a physical setting not likely to have a harmful effect on the proposed patient. The court shall receive all relevant and material evidence which may be offered, including the testimony or written findings and recommendations of the treatment facility or examiner who has examined or evaluated the proposed patient and the testimony ~~and~~ *or* written findings and recommendations of the ~~investigators~~ *investigator* appointed pursuant to ~~subsection (b) of K.S.A. 59-2915~~ *K.S.A. 59-2914 and amendments thereto*. Such evidence shall not be privileged for the purpose of this hearing.

The rules governing evidentiary and procedural matters at hearings under this ~~act~~ shall be applied so as to facilitate informal, efficient presentation of all relevant, probative evidence and resolution of issues with due regard to the interests of all parties. ~~*Hearsay evidence may be received and, consistent with law, experts and other witnesses may testify to any relevant and probative facts at the discretion of the court.*~~

If the applicant is not represented by counsel, the county or district attorney shall represent the applicant, prepare all necessary papers, appear at the hearing and present such evidence as the county or district attorney shall determine to be of aid to the court in determining whether the proposed patient is a mentally ill person.

Upon the completion of the hearing, if the court or jury finds by clear and convincing evidence that the proposed patient is a mentally ill person, ~~and after a careful consideration of reasonable alternatives to inpatient treatment,~~ the court shall order treatment for such person at ~~any~~ *a* treatment facility. An order for treatment in ~~any~~ *a* treatment facility, except a state psychiatric hospital, shall be conditioned upon the consent of such facility.

When the court orders treatment, it shall retain jurisdiction to modify, change or terminate such order.

If, upon the completion of the hearing the court or jury finds

[section

shall be sent by mail to the patient, the patient's attorney and the treatment facility to which the patient had been ordered.

Sec. 21. K.S.A. 59-2924 is hereby amended to read as follows: 59-2924. (a) The ~~director of mental health and retardation services~~ *secretary of social and rehabilitation services or the secretary's designee* may transfer any patient from any ~~institution under the director's control to any other such institution when ever the director~~ *state psychiatric hospital under the secretary's control to any other state psychiatric hospital whenever the secretary or the secretary's designee* considers it to be in the best ~~interest~~ *interests* of the patient.

(b) The secretary of social and rehabilitation services or the designee of the secretary may transfer any involuntary patient from any state psychiatric hospital to any state institution for the mentally retarded whenever the secretary of social and rehabilitation services or the designee of the secretary considers it to be in the best interests of the patient. Any patient transferred as provided in this subsection shall remain subject to the same statutory provisions as were applicable at the hospital from which that the patient was transferred and in addition thereto shall abide by and be subject to all the rules and regulations of the institution to which the patient has been transferred. The patient's next of kin or guardian, if one has been appointed, shall be notified of the transfer, and notice shall be sent to the committing court. No involuntary patient shall be transferred from a state psychiatric hospital to a state institution for the mentally retarded unless the superintendent of the receiving institution has found that the patient is mentally retarded and in need of care and training and that placement in the institution is the least restrictive alternative available. Nothing in this subsection shall prevent the secretary of social and rehabilitation services or the designee of the secretary from allowing a person to be admitted as a voluntary resident to a state institution for the mentally retarded, or from discharging such person from a state psychiatric hospital.

(c) When any proposed patient or involuntary patient has been ordered to any treatment facility ~~on referral or for treatment~~

[Except in the case of an emergency, the patient's next of kin or guardian, if one has been appointed, shall be notified of the transfer, and notice shall be sent to the committing court, not less than 14 days before the proposed transfer. The notice shall state the location to which the transfer is proposed and state that, upon request of the next of kin or guardian, an opportunity for a hearing on the proposed transfer will be provided by the secretary of social and rehabilitation services prior to such transfer

[Except in the case of an emergency,

[, not less than 14 days before the proposed transfer. The notice shall state the location to which the transfer is proposed and state that, upon request of the next of kin or guardian, an opportunity for a hearing on the proposed transfer will be provided by the secretary of social and rehabilitation services prior to such transfer

lows: 59-2928. *(a)* Restraints or seclusion shall not be applied to a patient unless it is determined by the head of the treatment facility or a ~~member of the medical staff~~ to be required to prevent substantial bodily injury to such patient or others. The extent of the restraint or seclusion applied to the patient shall be the least restrictive measure necessary to prevent injury to the patient or others, and the use of restraint or seclusion shall not exceed three ~~(3)~~ hours without medical reevaluation, except that such medical reevaluation shall not be required, unless necessary, between the hours of ~~12 o'clock~~ *12:00* midnight and 8:00 ~~o'clock~~ a.m. The head of the treatment facility or a ~~member of the medical staff~~ shall sign a statement explaining the ~~medical~~ necessity for the use of any restraint and seclusion and shall make such statement a part of the ~~medical~~ record of such patient.

(b) The provisions of subsection (a) shall not prevent:

(1) Staff at the state security hospital from confining patients in their rooms when it is considered necessary for security or proper institutional management;

(2) the use of such restraints as necessary for a patient who ~~cannot maintain a safe posture~~ without the use of such restraints; or

(3) the use of restraints when needed primarily for examination or treatment or to insure the healing process.

Sec. 24. K.S.A. 59-2929 is hereby amended to read as follows: 59-2929. *(a)* Every patient being treated in any treatment facility, in addition to all other rights preserved by the provisions of this act, shall have the following rights:

(1) To wear ~~his or her~~ *the patient's* own clothes, keep and use ~~his or her~~ *the patient's* own personal possessions including toilet articles and keep and be allowed to spend ~~his or her~~ *the patient's* own money;

(2) to communicate by telephone, both to make and receive confidential calls, and by letter, both to mail and receive unopened correspondence, except that if the head of the treatment facility should deny a patient's right to mail or to receive unopened correspondence under the provisions of subsection (b) ~~of this section~~, such correspondence shall be opened and examined

[physician or psychologist

[treatment

[permanent treatment

[, for a period not exceeding two hours without review and approval thereof by the head of the treatment facility or a physician or psychologist

[is likely to cause physical injury to self or others

New Sec. 18. (a) Following the hearing on the petition as provided for in K.S.A. 59-2917 and amendments thereto, or prior to the entry of an order provided for in K.S.A. 59-2918 and amendments thereto, if the court finds that the proposed patient is a mentally ill person, the court, as an alternative to inpatient treatment, may enter an order for outpatient treatment at a community mental health center or other private treatment facility capable of providing outpatient care. Such an order for outpatient treatment may be entered by the court only if the court finds that outpatient treatment will not constitute a danger to the community and that the patient is not likely to cause harm to self or others while under outpatient treatment. In considering this issue the court shall take into consideration all relevant factors, including but not limited to the degree of supervision and type of outpatient treatment proposed and available and the degree of security to the community provided for under outpatient treatment.

(b) No order for outpatient treatment shall be entered unless the outpatient treatment facility has previously evaluated the proposed patient, submitted a report recommending outpatient treatment and consented to treat the patient on an outpatient basis under the terms and conditions set forth by the court.

(c) If outpatient treatment is ordered, the order shall state the specific conditions to be followed by the patient and shall include the general condition that the patient shall follow

all directives and treatment methods established by the head of the treatment facility or the head's designee. The court shall also make such orders as are appropriate to provide for transportation to the outpatient treatment facility and provisions for monitoring the proposed patient's progress and compliance with outpatient treatment.

(d) The court shall retain jurisdiction to modify or revoke its order for outpatient treatment at any time on its own motion, on the motion of any counsel of record or upon notice from the treatment facility of any need for new conditions in the order for outpatient treatment or of material noncompliance by the patient with the order for outpatient treatment. Revocation or modification may be ordered by ex parte order or by order of the court after notice and hearing.

The treatment facility shall immediately report to the court any material noncompliance by the patient with the outpatient treatment order. Such notice may be verbal or by telephone but shall be followed by a verified written notice to the court and to counsel for all parties. Upon receipt of telephone, verbal or written verified notice of noncompliance, the court may enter an ex parte order of protective custody revoking the outpatient treatment order and providing for immediate commitment to an inpatient treatment facility.

After the entry of an ex parte order revoking or modifying the order for outpatient treatment, a copy of the order shall be served upon the patient and the patient's attorney. Any party to

the matter, including the petitioner, the state or the patient may request a hearing on the matter if the request is filed within five days from the date of service of the ex parte order upon the patient. The court may also order such a hearing on its own motion within five days from the date of service of the notice. If no request or order for hearing is filed within the five-day period, the ex parte order shall become the final order of the court. If a hearing is requested, a written motion for revocation or modification of the outpatient treatment order shall be filed by the state or the petitioner and a hearing shall be held thereon within five days after the filing of the motion. If upon hearing the court finds that the conditions of the outpatient treatment order have not been met, the court may enter an order for inpatient treatment or may continue the order for outpatient treatment with different terms and conditions.

(e) The outpatient treatment facility shall comply with the provisions of section 20 concerning filing of medical records summaries each 90 or 180 days during the time the outpatient treatment order is in effect and the court shall receive and process such reports in the same manner as reports received from an inpatient treatment facility.

CHARLES E. ANDREWS, JR.
ATTORNEY AT LAW
SUITE A. 1243 S. TOPEKA
TOPEKA. KANSAS 66612
913/234-0040

March 1, 1985

Representative Sandy Duncan
Chairman, Subcommittee on HB 2050
State Capitol Building
Topeka, Kansas 66612

Re: Proposals on HB 2050

Dear Representative Duncan:

After careful consideration of HB 2050, and after lengthy discussion with my colleagues, including of course Judge Mary Schowengerdt, I propose the following changes to the bill:

K.S.A. 59-2092 (Page 2)

(g) "Likely to cause harm to self or others" means that

(1) the person is likely, in the reasonable foreseeable future and with a reasonable degree of certainty, to cause physical injury or physical abuse to self or others;

(2) is substantially unable to provide for any of the person's basic needs, such as food, clothing, shelter, health or safety, except that a person's indigency shall be taken into consideration with respect to providing these needs; or

(3) is suffering severe and abnormal mental or emotional distress causing a substantial deterioration of the person's ability to function on the person's own accord.

K.S.A. 59-2914 (Page 15)

(6) An order of investigation, which investigation may inquire into the proposed patient's character, family relationships, past conduct, and other pertinent factors. That the purpose of the investigation shall be to determine whether or not the proposed patient is likely to cause harm to self or others if allowed to

Attachment No. 5
House Judiciary
March 4, 1985

remain at liberty. The court may designate a licensed social worker from a treatment facility, court services or social service agency to conduct the investigation and to promptly make a written report to the court which report shall be made available only to counsel for the parties at least five days prior to the date set for the hearing under K.S.A. 59-2917 and amendments thereto.

K.S.A. 59-3002 (Page 46)

(c) "Meet essential requirements for physical health or safety" means those actions necessary to provide the health care, food, shelter, clothing, personal hygiene and other care without which serious physical injury or illness is more likely than not to occur; that a person's indigency shall be taken into consideration with respect to that person's ability to provide those needs.

With respect to the definitional changes contained in K.S.A. 59-2902(g)(1), it is strongly felt that the addition of the words "with a reasonable degree of certainty" compromises the philosophical differences which exist between the department and the legal spectrum. I believe it narrows the impact of the word "likely" which has appeared in every draft of HB 2050. I do not believe, however, that it substantially restricts the new definition which is certainly broader than the current definition. Under (g)(2) we feel that Representative Solbach's concern for the indigent's ability to provide basic needs is properly addressed. Further, under (g)(3) the word "accord" was added simply to clean up the sentence.

It is felt that the addition of the words "licensed social worker" and removing the word "officer" will make the discretionary investigation contained in K.S.A. 59-2914 more easily accepted. The reason for this is obvious . . . a licensed social worker is better educated, trained and otherwise qualified

to conduct such an investigation. Further, we feel that a social worker would be more attuned to the sensitivity of such a confidential matter. Further, the section was redrafted for purposes of language "clean up."

Finally, changes in the guardianship code are suggested to maintain some consistency in the definitions. Again, this was done to alleviate Representative Solbach's concern about an indigent's ability to meet essential requirements.

I trust that these changes will be acceptable to your committee. While philosophical differences may continue to exist on Article 29, nonetheless it is felt that we can ameliorate those differences with neither side substantially sacrificing their principles.

Thanking you for your kind attention to this matter,

Very truly yours,

CHARLES E. ANDREWS, JR.

CEA/dr

I have read the above and foregoing and endorse its contents.

Judge Mary Schowengerdt

WILLIAM L. ALBOTT, Ph.D.
Certified Psychologist - State of Kansas

1607 Boswell • Topeka, Kansas 66604 • 913-232-5288

Representative S. Duncan
House of Representatives
State Capitol Building
Topeka, KS

Dear Representative Duncan:

I am writing you in regard to H.B. 2050, as amended by recommendation by your sub-committee of the House Judiciary Committee. My observation of the committee hearing on February 28, 1985, was that the bill has some distance to go before it has wide spread support. I hope that the committee does not send the bill to interium study.

Realizing that more changes may be more than the proverbial legislative camel can bear, I am below identifying some additional items/areas which you might want to consider as being technical clean-up rather than substantive changes.

Page -1- (c) "Head of the treatment facility" means the administrative director of a treatemtn facility if the administrative director is a physician or psychologist or, if the administrative director is not a physician or psychologist ~~the chief medical officer~~, a physician or psychologist designated by the ~~chief medical officer~~ administrative director.

NO

not considered

New section 18, 6th line -- delete the words "community mental health center or other private" - This is already included in the definition of a Treatment Facility.

Page 39 line 390-391 "...periodic psychiatric or psychological treatment ~~or guidance counseling~~.

Page 39 lines 398-399 insert after "psychiatric or psychological and then delete "or guidance counseling".

OK

OK

Page 40 line 436 insert after medical officer the phrase "or treatment facility"

OK

New Section 37 typed page -3- line 3 delete the words "the hospital, clinic" and insert the words "a treatment facility, a".

Page 31 new section (e)
"The head of the treatment facility shall not modify the treatment plan or ....."
"...intention to modity the treatment plan or discharge..."

NO

This last change is in my opinion a substantive change and is

Attachment No. 6
House Judiciary
March 4, 1985

consistent with the intent of this bill to offer additional assurance that patient rights will be truely protected.

Page -49- line 240 ....ward~~, to psychosurgery,~~ removal..

NO

Page 49 new section (8) "to consent, on behalf of a ward, to psychosurgery."

It is my personal belief that a guardian should not be allowed to make this decision, but instead it should be a decision of the court alone.

Sincerely yours,

Bill

William L. Albott, Ph.D.
Certified Psychologist--Kansas

Session of 1985

HOUSE BILL No. 2065

By Committee on Judiciary

1-24

AN ACT ~~concerning state institutions for the mentally retarded;~~ ~~relating to confidentiality of records;~~ [relating to mentally retarded persons and other persons with developmental disabilities; concerning disclosure of certain records relating thereto

Be it enacted by the Legislature of the State of Kansas:

Section 1. (a) The records of any resident or former resident of a state institution for the mentally retarded that are in the possession of the institution shall be priviledged and shall not be disclosed except under any of the following conditions:

(1) Upon the written consent of: (A) The resident or former resident; ~~(B)~~ a parent, if the resident or former resident is under 18 years of age~~; or (C) the guardian, if the resident or former resident has a guardian~~. The superintendent of the institution which has the records may refuse to disclose portions of such records if the superintendent states, in writing, that the disclosure will be injurious to the welfare of the resident or former resident. [, if an adult who has no guardian; (B) the resident's or former resident's guardian, if any; or (C)

(2) Upon the sole consent of the superintendent of the institution which has the records after a written statement by the superintendent that the disclosure is necessary for the care, training or treatment of the resident or former resident. The superintendent may make the disclosure to the resident or former resident, the resident's next of kin, any state or national accreditation agency or any scholarly investigator without making that determination, but, before the disclosure is made, the superintendent shall require a pledge from any state or national accreditation agency or scholarly investigator that such agency or investigator will not disclose the name of any resident or former resident to any person not otherwise authorized by law to receive that information.

(3) Upon the order of any court of record after a determina-

Attachment No. 7
House Judiciary
March 4, 1985

tion by the court that the records are necessary for the conduct of proceedings before it and are otherwise admissible ~~in~~ evidence. [as

(b) Violation of this section is a class C misdemeanor. [Willful

Sec. ~~2~~. This act shall take effect and be in force from and after its publication in the statute book. [3

New Sec. 2. (a) The agency desiganted as the developmental disabilities protection and advocacy agency pursuant to P.L. 94-103, as amended, shall have access to records of a person with a mental retardation or other developmental disability who resides in a public or private facility for persons with developmental disabilities if:

(1) A complaint has been received by the agency from or on behalf of such person; and

(2) such person does not have a legal guardian or the state or a designee of the state is the legal guardian of such person.

(b) Willful failure to allow access to records as provided by subsection (a) is a class C misdemeanor.

(4) To appropriate administrative or professional staff of any licensed Kansas facility for the mentally retarded for the purposes of promoting continuity of care in the community following discharge or conditional placement. The consent of the resident or former resident, or if applicable the parent or guardian of the resident or former resident, shall not be necessary to release information to licensed Kansas facilities for the mentally retarded.

(5) To any other person if such disclosure is required by federal law or regulation implementing a federal grant-in-aid program in which the state is participating.

(6) As provided in section 2.