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A Primer For Construction Bankruptcies

Law360, New York (December 23, 2011, 1:53 PM ET) -- In general, a company has two bankruptcy alternatives: liquidation under Chapter 7 and reorganization under Chapter 11.

Under Chapter 7, upon the filing of a bankruptcy petition, a trustee is appointed to gather and sell all of the debtor's assets as quickly as possible. Once the trustee liquidates all of the assets, it must pay creditors in accordance with the priority scheme mandated by the Bankruptcy Code:

- Claims secured by collateral;
- Claims entitled to priority or administrative expense priority treatment such as certain tax claims and the costs of administering the bankruptcy estate;
- General unsecured creditors; and
- Equity.

The trustee will pay creditors in whole dollars until it can no longer do so, in which case it will make a pro rata distribution to creditors at the same level of priority. There is no assurance that general unsecured creditors will receive any distribution.

Chapter 11 is generally a long, involved process. The debtor, who remains in possession and control of its business, negotiates with its creditors, and then proposes and files a plan of reorganization with the Bankruptcy Court. The debtor's plan of reorganization, once confirmed by the Bankruptcy Court, governs how the debtor will continue to conduct business and in what manner it will satisfy the claims of its creditors (repayment of claims generally follows the priority scheme noted above). Debtors generally use Chapter 11 to reorganize as a viable business, to sell the business as a going concern or, increasingly, to liquidate the assets of the business in a manner that is more orderly than under Chapter 7 liquidation.

One of the primary benefits of filing for bankruptcy (either Chapter 7 or 11) is that the bankruptcy filing itself stops all legal actions against the debtor. This is known as the "automatic stay" in bankruptcy. The automatic stay acts as an injunction or a "shield" which prohibits creditors from beginning or continuing litigation, collection activity, or in the case of a construction contract, a general contractor's efforts to terminate the debtor's subcontract. Once the debtor files for bankruptcy, any creditor looking to take any action against the debtor or its property must first obtain permission from the Bankruptcy Court.

At some point during the bankruptcy case, a deadline will be imposed for filing claims against the debtor, known as a bar date. Bankruptcy Courts strictly enforce bar dates. A contractor that is owed money from a subcontractor or owner who files for bankruptcy should consider filing a proof of claim in the bankruptcy case for amounts owed by the debtor.

Contracts

Construction contracts are considered "executory" contracts under the Bankruptcy Code. The debtor may either assume or reject such contracts. A debtor generally has until confirmation of its plan to make a decision whether to assume or reject a contract; however, the court, at the request of a counterparty, may order the debtor to make its decision within a specified period of time.

If the debtor decides to assume the contract, it must cure all defaults, including paying any past due payments and continuing with its performance on the contract. The debtor must also prove that it can adequately perform the contract going forward. If the debtor decides to reject the contract, the debtor loses all of the benefits of the contract. Past due payments owing to the nondebtor counterparty under a rejected contract become general unsecured claims and the counterparty may also have a damages claim for breach of contract.

A contract that has expired or otherwise terminated prior to the bankruptcy filing may not be assumed or rejected. Thus, if the contract is terminated prior to the bankruptcy filing, the contract does not come into the bankruptcy estate and is not administered as part of the bankruptcy case. Most construction contracts contain a provision that permits the nondebtor party to immediately terminate the contract upon the debtor filing for bankruptcy protection. This bankruptcy default is known as an "ipso facto clause" and is not enforceable in bankruptcy. If the nondebtor party wishes to terminate the contract after the bankruptcy filing, it must get permission from the Bankruptcy Court.

When a debtor continues to properly discharge its contractual obligations, the contractor may want to continue working with the debtor despite the bankruptcy. The contractor should consider attempting to protect its rights and interests by requiring the debtor to file an assumption stipulation with the Bankruptcy Court. The contractor can build into the assumption stipulation several advantages and protections that may not exist in the contract. Some of these protections include:

- Strict performance milestones;
- A joint-check provision;
- Expedited termination provisions in the event of a subsequent breach by the debtor;
- The ability to replace the debtor in the event of a subsequent breach by the debtor; and
- The right to immediately set off any damages caused by the debtor's breach against any funds that may be due to the debtor.

Liens

Every state grants lien rights to contractors that contributed to a project. These lien rights must be protected under applicable state law because in bankruptcy, failure to perfect lien rights may allow the debtor to avoid the unperfected lien and reclassify the claim to general unsecured claim status.

Notwithstanding the automatic stay, the Bankruptcy Code permits contractors to perfect and maintain lien rights (e.g., providing pre-lien notices and recording a claim of lien) after the bankruptcy filing if such rights could have been perfected or maintained under applicable state law but for the bankruptcy filing.

Although the Bankruptcy Code permits acts to perfect and maintain lien rights, it does not permit any act to enforce such rights against the debtor during the bankruptcy case. Any enforcement activity can occur only after obtaining permission from the Bankruptcy Court. Note that the automatic stay does not protect nondebtor parties. Thus, a debtor's bankruptcy will not prevent a party from pursuing (and enforcing) lien rights and other remedies against nondebtor contractors, property owners, or other third parties, including

sureties and guarantors, who may be liable on the claim.

Setoff

Construction contracts (and common law) often allow the contractor to withhold and charge back against the debtor amounts due unpaid sub-subcontractors and suppliers. The debtor may demand payment from the contractor even though the debtor caused damages to the contractor by failing to timely complete a job. These are examples of setoff rights, which are preserved under the Bankruptcy Code. The automatic stay, however, prevents a contractor from realizing on these rights unless and until the contractor receives authorization from the Bankruptcy Court to setoff the obligations.

Direct Pay

Some contracts provide that if the debtor fails to pay its subcontractors or suppliers, the contractor may withhold payment to the debtor and pay the sub-subcontractors and suppliers directly. Some Bankruptcy Courts have relied on direct pay provisions to find the bankruptcy estate has no interest in these funds and that the contractor may bypass the debtor and make payment directly to the lower-tier subcontractors and suppliers.

Not all Bankruptcy Courts enforce direct pay provisions, so it is prudent to obtain court authority before making such direct payments. In addition, to the extent that the Bankruptcy Court does permit direct payments, the contractor should not pay any lien claimants until they have taken all necessary steps to perfect their liens.

Replacing the Subcontractor

If the debtor ceases performing work on a project, the contractor should immediately, on an emergency or expedited basis, make a motion with the Bankruptcy Court to remove the debtor from the project and replace the debtor with another subcontractor. The replacement must be effectuated pursuant to court order to avoid violating the automatic stay and any contempt damages that could follow from that violation. If the cost of the replacement subcontractor is more than what the contractor would have paid the debtor, the contractor has an unsecured claim against the debtor for the difference.

Joint Check

Some contracts provide that a contractor may pay a subcontractor and its sub-subcontractor or supplier by joint check such that the subcontractor cannot cash the check without the signature of the supplier, thereby ensuring that the subcontractor pays the supplier with proceeds from the check. A financially distressed subcontractor that is not bound by a joint check provision could use the funds for other purposes, leaving the lower-tier subcontractor or supplier unpaid and giving rise to liens claims that the contractor must discharge.

Some Bankruptcy Courts have required debtors to continue to pay their subcontractors and suppliers under pre-bankruptcy joint-check agreements. The rationale employed by these courts is that the funds do not really belong to the debtor if the intent of the parties was to ensure that the funds were paid to the supplier. Contractors may be able to enforce properly drafted joint-check provisions to ensure appropriate payments are made.

Preferences

Filing a bankruptcy case gives the debtor (but not a creditor) the ability to avoid and recover certain transfers it made within the 90-day period prior to the bankruptcy filing. These transfers are known as preferences in bankruptcy circles. In order for preference payments to be avoided, the debtor must demonstrate, among other things, that the

payment was the property of the debtor, made on account of an existing debt, and permitted the creditor to receive more than it would have in Chapter 7 liquidation.

A classic preference fact pattern could be where an owner makes a payment to the contractor for amounts owed under a contract for services already rendered and then the owner files for bankruptcy within 90 days of making the payment. The Bankruptcy Code also provides several defenses to preferences, including an ordinary course of business defense, a new value defense, and a contemporaneous exchange defense.

One area that may be ripe for preference attack is the situation where a subcontractor executes a lien waiver, is not in fact paid, and files for bankruptcy prior to filing the affidavit of nonpayment. There is some potential that the debtor could assert that the contractor would be receiving more than it is entitled to receive under Chapter 7 if it did not pay for the work subject to the lien waiver.

Frequently Asked Questions

Q: If a contractor learns that a subcontractor is in financial distress or receives notice that the subcontractor is closing down its business, what should the contractor do?

A: Terminate the contract before a bankruptcy filing by following the procedures set forth in the contract. If the contractor does not effectively terminate the contract prior to the bankruptcy, then the contractor must obtain Bankruptcy Court approval before terminating the contract post bankruptcy.

Additionally, unless lien waivers are received, use joint checks or do not make further payments. In this situation, the contractor wants to be sure that payments reach the sub-subcontractors and suppliers who actually performed the work for which payment is sought by the subcontractor, so lien waivers should be obtained from these lower tier entities.

Q: If a subcontractor files for bankruptcy, can the contractor pursue rights under the subcontractor's performance bond?

A: Yes — the automatic stay applies to and prevents acts against the debtor. The stay does not prevent acts against the subcontractor's performance bond surety or any guarantors.

Q: If a subcontractor files for bankruptcy, what can the contractor do to expedite assumption or rejection of the contract?

A: As a counterparty to a contract with a debtor, the contractor could file a motion with the court to compel the debtor to assume or reject the contract. Assumption means the debtor reaffirms the contract and must perform according to its terms. In order to assume a contract, the debtor must cure all past defaults and must convince the judge that it can perform under the contract in the future.

An assumed contract can be modified if the parties to it agree to do so. By rejecting the contract, the debtor is breaching it as of the date of the bankruptcy filing. Nonperformance under the contract by the debtor may be sufficient grounds for the contractor to bring a successful motion to force the debtor to reject the contract. If the debtor rejects the contract, the contractor is then free to arrange for the remaining work to be performed by another subcontractor.

Q: What steps can a contractor take to protect itself from a subcontractor bankruptcy?

A: Some pre-bankruptcy considerations a contractor can build into the contract include an explicit right of setoff for all jobs with the subcontractor, joint check provisions, and periodic lien waiver requirements including lien waivers from sub-subcontractors and lower tier

suppliers.

It is always important for a contractor to make sure on a regular basis that amounts paid to a subcontractor on account of work performed by a sub-subcontractor or material supplied by a lower tier supplier are timely paid by the subcontractor to the lower tier subcontractors and suppliers and are not diverted by the subcontractor to another purpose. These lower-tier subcontractors and suppliers if unpaid could assert lien claims or payment bond claims against the contractor's payment bond which would survive a subcontractor bankruptcy.

If the contractor no longer wishes to do business with the subcontractor and grounds exist to terminate the contract, the contractor should act quickly to terminate the contract prior to the bankruptcy filing. A contract terminated prior to the bankruptcy does not become part of the bankruptcy case. But termination must be done in accordance with the procedures set forth in the contract.

Q: If an owner files for bankruptcy, can the contractor keep working for the owner?

A: If a valid contract exists between the contractor and owner, the contractor must continue to perform pursuant to the terms of the contract, even if the debtor does not. The contractor will be entitled to be paid according to the terms of the contract and will have an administrative expense priority claim for any unpaid, post-bankruptcy amounts due. As noted above, if the debtor does not perform its obligations under the contract, the contractor can, and should, seek to force the debtor to assume or reject the contract, or seek relief from the stay in order to terminate the contract.

Q: If an owner files for bankruptcy, can the contractor pursue lien rights?

A: The automatic stay prevents enforcement of lien rights. The Bankruptcy Code provides an exception to the stay for ministerial acts necessary to perfect and maintain lien rights (e.g., providing pre-lien notices and recording a claim of lien) after the bankruptcy filing, if such rights could have been perfected or maintained under applicable state law but for the bankruptcy filing. The date of perfection of the lien relates back to the date that it would have been perfected under applicable state law.

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