

## Expert Q&A on Contractor Distress, Construction Law, and Bankruptcy

by Practical Law Bankruptcy & Restructuring

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An Expert Q&A with Samuel M. Tony Starr, Caitlin A. Hill, and Timothy J. McKeon of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., discussing contractor distress and the intersection of construction law and bankruptcy.

The duration of the COVID-19 pandemic has upended many industries. While the construction industry has largely been able to operate throughout the pandemic, albeit with increased and ever-changing restrictions on jobsites, one consequence has been many construction-related bankruptcy filings. Already in 2021, there have been more than 100 construction-related bankruptcy filings across the country. For many property owners and real estate developers, these filings create a nightmare scenario where work may slow or even stop entirely. Practical Law asked Samuel M. Tony Starr, Caitlin A. Hill, and Timothy J. McKeon of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. to discuss how property owners and real estate developers can protect themselves and their projects from downstream distress.

Samuel M. Tony Starr is a litigator and construction attorney working with contractors, owners, developers, and public authorities. He represents clients in significant construction litigation, arbitrations, and mediations. Caitlin A. Hill practices complex litigation including contract disputes, commercial and business litigation, complex tort and product liability litigation, and construction law. She advises contractors, owners, developers, and public authorities in all stages of litigation. Timothy J. McKeon's practice is focused on bankruptcy and restructuring matters. He has represented Chapter 11 debtors, secured and unsecured creditors, indenture trustees, and defendants in bankruptcy litigation matters.

### What are some red flags to watch out for regarding a contractor's financial condition?

Property owners and real estate developers must be vigilant about recognizing the red flags that precipitate or indicate contractor distress and ensure to identify them either as events of default or notice events. Examples of common red flags include:

- Termination of a key employee.
- Failure to maintain an adequate workforce.
- Delayed deliveries of materials to a project site.
- Termination of a subcontractor.
- Mechanic's liens filed against the project or the property by a subcontractor or supplier.
- Withdrawal of trade credit by vendors.

These events all may indicate a range of issues with the contractor, such as:

- Financial distress.
- Problems with an individual project.
- Loan default.
- Inability to complete a contract.

Owners and developers that can identify these events early are better positioned to avoid unwanted surprises.



For further guidance on how to identify contractors in distress, see [Doing Business with Troubled Customers: Trade Creditors' Prepetition Checklist: Identify Troubled Customers and Gather Information](#).

To facilitate this type of oversight, owners and developers should consider including provisions in their contracts that allow for routine review of schedules, milestones, and other important submittals during a job.

### How can a property owner or real estate developer contractually protect themselves in the event of a contractor's bankruptcy?

A bankruptcy filing by a contractor can create uncertainty and delays on a job site because owners are restricted in what actions they can take against the contractor, while the contractor can continue to enforce its contract with the owner. This is true even if the contract provides that it terminates if a contractor files for bankruptcy because these provisions, known as *ipso facto* clauses are not enforceable in bankruptcy (§ 365(e)(1), Bankruptcy Code and see [Standard Clause, Ipso Facto Clause](#)).

For more information on *ipso facto* clauses, see [Practice Notes, Executory Contracts and Leases: Overview: Consequences of Assumption to Non-Debtor Party and Executory Contracts and Leases in Bankruptcy: Strategies for Non-Debtors: Drafting Contracts](#).

Consequently, the surest way to avoid exposure to the risks and delays of a contractor bankruptcy is to terminate and replace a distressed contractor before a bankruptcy filing occurs. This is obviously easier said than done which is why identifying potential red flags is so crucial. By ensuring that a contract allows for an expeditious termination process, an owner can increase the odds that the contract is no longer effective or even curable by the time a contractor files for bankruptcy.

For example, owners may consider including contract provisions that allow for:

- Termination for convenience (see [Standard Clause, Termination for Convenience of Owner \(Construction\)](#)).
- A shortened cure period following notice of a default.
- Immediately effective notice of default by email.

If the owner isn't able to terminate the contract before bankruptcy, it must tread cautiously to ensure compliance with the bankruptcy rules and procedures.

### Which parts of the bankruptcy process directly affect property owners and real estate developers in the event of a contractor bankruptcy?

#### Automatic Stay

Immediately on filing for bankruptcy, a debtor is protected by the automatic stay. The automatic stay prohibits most collection and enforcement actions against a debtor, unless authorized by the bankruptcy court. An owner, therefore, must request relief from the automatic stay from the bankruptcy court if it wishes to terminate an agreement with a contractor-debtor. Relief, however, is not immediate nor guaranteed and can be expensive.

In anticipation of this issue, owners may wish to require that a contractor agree that, if the contractor files for bankruptcy, it cannot oppose a request by the owner for relief from the automatic stay. The enforceability of this waiver, however, is not guaranteed and an owner still must satisfy its burden under the Bankruptcy Code to demonstrate cause to lift the stay (see [Standard Clause, Waiver of Automatic Stay](#)).

For more information on the automatic stay in bankruptcy, see [Practice Note, Automatic Stay: Overview](#).

#### Mechanic's Liens

In some jurisdictions, the automatic stay imposed by a general contractor's bankruptcy filing may prevent a subcontractor from filing a mechanic's lien against an owner's property even though the owner is not a debtor in bankruptcy. The issue of whether a subcontractor has violated the automatic stay by filing a mechanic's lien is a question of state law regarding how and when mechanic's liens are created and perfected, as well as how these liens are satisfied. Whether a mechanic's lien that is properly filed by a subcontractor against an owner's property and that pre-dates a general contractor's bankruptcy or relates back to the prepetition period survives a bankruptcy is also primarily governed by state law.

For more information on filing mechanic's liens, see [Mechanic's Lien Toolkit](#).

## Assumption and Rejection of Executory Contracts

A construction contract is likely to be considered an executory contract in bankruptcy, which allows a contractor-debtor to either:

- Assume and either continue to operate under or assign the contract to a third party, which requires that any defaults are cured.
- Reject the agreement.

The Bankruptcy Code provides that a debtor has until confirmation of a plan of reorganization to make these decisions. This is true even if the agreement provides that it automatically terminates on the filing of bankruptcy because, as noted, these *ipso facto* provisions are not enforceable under the Bankruptcy Code. Owners, however, may want a contractor-debtor to assume (and cure existing defaults) or reject (and allow the owner to replace the contractor) an agreement before confirmation to allow for greater certainty regarding the performance of a project. For more information on the treatment of executory contracts in bankruptcy, see [Practice Note, Executory Contracts and Leases: Overview](#).

To expedite the assumption or rejection process, an owner may want to negotiate for the inclusion of a requirement in its contracts that, if a contractor files for bankruptcy, the contractor agrees to assume or reject the agreement within a specified time period, such as 30 or 45 days after filing bankruptcy.

However, the enforceability of this provision is not guaranteed because it may strengthen an owner or developer's argument that the debtor should be compelled to immediately assume or reject its agreement. Similarly, the inclusion of certain representations regarding the timing of a project and an acknowledgment of the damage to the project if the contractor fails to satisfy its obligations, may also be helpful to an owner's request.

## What are some issues with curing a construction contract in bankruptcy?

Calculating damages and identifying all defaults under a construction contract can be difficult and expensive. However, a debtor cannot assume an agreement without first curing the existing defaults. To help avoid costly disputes over identifying and calculating damages resulting from delay due to contractor default, agreements should include clearly drafted liquidated damages provisions.

Owners and developers should also negotiate for the right to review a contractor's books and records, financial statements, or other financial audit rights concerning a payment application or as a remedy for an event of default. It is crucial that the agreement not contain a waiver of consequential damages (unless there is a liquidated damages provision). These rights can help an owner needing to prove damages.

## How can owners avoid being on the hook for payments to subcontractors?

Owners and developers should be concerned that subcontractors or others are likely to look to them for payment that distressed contractors failed to make. To avoid this situation, owners should require contractors be bonded or provide for the use of joint checks at the owner's discretion. At a minimum, owners should require contractors to provide interim lien waivers or other evidence of timely payment to subcontractors with each progress requisition and this requirement should be diligently enforced.

For more information on lien waivers in construction contracts, see [Practice Note, Waivers and Releases in Construction Contracts: Drafting Strategies](#).

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