Chapter XII
BANKRUPTCIES IN A CONSTRUCTION SETTING

By: Stephen A. Hilger, Esq.
Rhoades McKee

The only mail which is feared more than an audit letter from the Internal Revenue Service is a notice that one of the parties with whom you have a construction contract has filed for bankruptcy protection. A bankruptcy can cause immeasurable difficulties for a construction project. These include not only the monetary problems associated with dealing with the bankruptcy, but schedule-related and other associated problems caused by the non-performance of the party going into bankruptcy. If an entity involved in a construction project that you are working on goes into bankruptcy, you should be aware of several key provisions in the bankruptcy code.

AUTOMATIC STAYS IN BANKRUPTCY

The first of these provisions is called the "Automatic Stay". Under the Automatic Stay, when a contracting party goes into bankruptcy, all actions by or against this entity basically stop. The automatic stay, which is applicable to all entities, puts a hold on the commencement or continuation of any judicial, administrative or other action or proceeding against the person or entity who filed the bankruptcy petition. The stay applies to any action that was or could have been commenced before the filing of the bankruptcy case, and basically operates to prevent the recovery of any claim against the filing party that arose before the commencement of the case. It prevents the enforcement of any debt against any property of the estate; any action to obtain possession of property; any action to create, perfect, or enforce a lien or a judgment against the party; and it prevents any action to collect any claim or apply any set-off. Basically, a stay prevents any action that disturbs the status quo. This means that all actions against the filing party must stop until you can sort out the obligations of all parties in the bankruptcy proceeding.

EXECUTORY CONTRACTS

For those entities having contracts with the filing party, which is called the Debtor, there is another provision in the Bankruptcy Code which provides for the assumption or rejection of the executory contracts. An executory contract is one for which the full performance by one party is not complete. In a bankruptcy setting, a Debtor or Trustee may assume an executory contract only with the court's approval. If the Debtor or the Trustee rejects the executory contract, it is treated as a default. You would then be entitled to file a claim in the bankruptcy proceeding for the default damages. In order for a Debtor to obtain court approval for the assumption of an executory contract, the Debtor or Trustee would be required to cure any default or to provide adequate assurance that the Trustee or Debtor will promptly cure any default, to compensate the contracting party for any actual pecuniary loss resulting from the default, and finally, to provide adequate assurance of future performance. This can be a huge impediment to a construction project. If an owner filed bankruptcy, a general contractor and all downstream contractors would not be required to perform until the court allowed an assumption of the contract with the general contractor. Likewise, the same rules apply between a general contractor and a subcontractor. There are perils in performing a contract which has not been assumed. If you do so, the Debtor will not be required to pay you. For performance which occurs between the time when the Debtor files the bankruptcy petition and a court orders approval of the assumption of the contract, you may risk not recovering expenditures incurred during that period. This could be disastrous for a construction schedule if the project was held up until a court set a hearing on assuming or rejecting a construction contract. Therefore, it is important that you act immediately on assumption of the contracts in the event that an entity with whom you have contracted on a construction project has filed a bankruptcy petition.

“PAY WHEN PAID” CLAUSES

Another important part of the Bankruptcy Code is the “turnover” section. Under these provisions, an entity in possession, custody or control of property that belongs to the Debtor’s estate must deliver that property or account for such property or the value of such property unless it is determined to be inconsequential to the estate. Any entity that owes a debt to the estate which has matured, is payable, or otherwise due must pay this debt to the estate, subject to a set-off under a different part of the Bankruptcy Code. This means that if a general contractor has received money from an owner which needs to be paid to a subcontractor, a conflict will arise between otherwise enforceable “pay-when-paid” language and the obligation under the Bankruptcy Code to turn over money to the estate of the subcontractor. When this happens, you need to review the Contract Documents very carefully to determine whether the payment condition is an actual contingency or merely a timing clause. If the pay-when-paid clause is actually a condition precedent, a general contractor possibly has an argument that money does not need to be turned over until it is due, which is when the general contractor receives that money from the owner. On the other hand, if the clause is merely timing in nature, a general contractor may be required to turn over the money to the estate irrespective of whether it has been received by the owner. The obligation to turn money over to the estate is dependent upon the state law interpreting the enforceability of the particular pay-when-paid language.

PREFERENTIAL PAYMENTS AND SETTING THEM ASIDE

Another provision of the Bankruptcy Code that has a material impact on construction projects is the “preference” section. Under the preference provision, if your company has been paid by an entity within ninety days prior to the filing of that entity’s bankruptcy proceeding, you may be required to pay that money back to the bankruptcy estate if you were a creditor, if you were receiving the money on account of an antecedent debt owed by the Debtor before the payment was made, if the payment was made within ninety days prior to the bankruptcy proceeding, and if that payment allows you to receive more than you would under a straight liquidation of the bankruptcy Debtor. Further, the ninety-day rule extends to one year if you are determined to be an “insider,” which includes having a parental relationship or otherwise being significantly connected to the bankruptcy estate. This provision causes many problems on construction projects. If a subcontractor pays a supplier on an account for supplies furnished to the construction project, and then the subcontractor goes into bankruptcy, the supplier will likely have to pay that money back to the bankruptcy estate if the transfer was made within ninety days prior to the filing of the bankruptcy petition. The supplier would then be left to file a proof of claim in the bankruptcy estate and share pro-rata with the remaining unsecured creditors. This is a particularly harsh remedy for those individuals receiving payment in the ordinary course of business. One exception to the preference provision occurs if the payment was intended to be a contemporaneous exchange of something called “new value” and the exchange was in fact substantially contemporaneous. For example, if a Debtor brings a check to a supplier and exchanges it for some material to be used on a construction project, this likely will not be a preference. The preference provisions are designed more for entities that carry running balances on accounts. Another exception to the preference provision is a debt incurred in the ordinary course or financial affairs of the Debtor and in accordance with ordinary business terms. Here again, if a transaction is made for which payment is provided, and that transaction is not made on an “account” basis, you might be able to survive the pay-back provisions of the preference section.

WARRANTIES IN BANKRUPTCY

Warranty provisions in contracts also provide a fertile ground for debate under the Bankruptcy Code. A warranty obligation is simply a continuing contractual obligation by one of the parties. If a party goes into bankruptcy, you may not have a pending warranty defect which would justify a claim against the estate. The problem arises when the warranty claim surfaces several months or even years after the filing of the bankruptcy petition. By then, it is typically too late to file a proof of claim. While in theory you could require the Debtor to assume or reject the contract, the Debtor would certainly argue that the contract is no longer “executory” but rather fully executed, so that the assumption provisions do not apply. This leaves the warranty holder basically holding the bag. This is a real problem for contractors and anyone in the construction industry. If this happens, you should try to see if an entity took over the debtor’s company, and

if so, whether continuing liabilities were assumed. If so, you may have a warranty claim against the new assuming company.

AUTOMATIC DEFAULT CLAUSES

Another question that typically arises in the bankruptcy setting is whether the automatic default clauses contained in most construction contracts are enforceable. These "*ipso facto*" or automatic default clauses typically provide that upon the insolvency of the Debtor or the filing of a bankruptcy petition, the contract is automatically deemed in default and the non-breaching party can therefore exercise a variety of remedies. However, these bankruptcy default contract provisions are not enforceable in most jurisdictions, so contracting parties cannot assume that they can take immediate default action against a party simply because that party filed for bankruptcy.

BONDS, LIENS AND BUILDER'S TRUST CLAIMS

The bonding obligations which exist on a construction project are generally not materially affected by most bankruptcies. A bond is a separate independent obligation provided by a bonding company either to the owner under a performance bond or to multiple downstream contractors and suppliers under a payment bond, and it will not be affected by the company's filing a bankruptcy petition.

Lien rights are also slightly affected in bankruptcy. If a bankruptcy is filed by a general contractor, it will not typically affect the ability of a subcontractor to obtain a lien on the owner's property, so long as all of the other aspects of the lien laws have been complied with. On the other hand, if the owner has filed a bankruptcy petition, general contractors and subcontractors will likely not be able to use the lien statutes effectively. This is because a construction lien is typically determined to be a "statutory lien" which is voidable by the bankruptcy estate. The security that a contractor once felt will probably be limited because that voidable statutory lien will now be viewed as an unsecured claim.

Many states have laws which indicate that if a principal owner of a construction company diverts money that is paid from an owner to a general contractor for downstream payments to subcontractors and suppliers, that principal owner may be personally obligated for the payment of that money. These are the "builder's trust" statutory provisions, and under most bankruptcy scenarios, these builder's trust obligations remain intact.

CONCLUSION

The filing of a bankruptcy petition by someone on a construction project can be a nightmarish quagmire of what may appear to be unresolvable issues. The best way to protect yourself is to act quickly. In acting quickly, you need to make sure that you conduct yourself in accordance with the provisions of the United States Bankruptcy Code, or you may be looking down both barrels of a contempt order from the bankruptcy court. The bottom line, however, is that you surely do not want to sit on your rights when it comes to protecting your interests in a bankruptcy proceeding.