

THE CONSTRUCTION

# SPECIFIER

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## Minimizing the Impact of Bankruptcy

**M**ost construction projects are very time sensitive due to, among other things, cost. Moreover, most participants in the construction process depend heavily on regular and timely progress payments. Thus, there is an expectation that within 30 to 45 days of an application for payment, progress payments will begin to flow down to the respective subcontractors and material suppliers. The orderly flow of payments can be thrown into chaos when one of the participants files a bankruptcy.

For example, assume the perspective of a general contractor on a \$20 million commercial construction job. The HVAC subcontractor, expected

to work on the job for seven weeks, is three weeks into the job. There are rumors that the subcontractor is not current on its bills, and some laborers report that during one recent pay period, their checks bounced. Shortly after,

the HVAC subcontractor files for Chapter 11 protection in the U.S. Bankruptcy Court and walks off the job.

Generally, the general contractor might send a notice of default to the HVAC subcontractor. In response, the contractor will probably receive a curt letter from a bankruptcy attorney announcing that the "termination letter" constitutes a violation of the automatic stay provisions of the Bankruptcy Code, which protect debtors from creditor collection efforts during bankruptcy.

Moreover, the HVAC subcontractor's failure to pay its subcontractors, material suppliers, and laborers may result in a trail of stop notices, bond claims, and mechanic's liens. Finally, the HVAC subcontractor through its legal counsel may assert that the progress payment that should have been used to pay the HVAC subcontractor's materials and labor costs is "property of the estate" and that the funds will not be released to satisfy the liens.

### Key Legal Concepts

Three key legal concepts of bankruptcy are illustrated in this scenario. First, when a party files a bankruptcy, an automatic stay on all collection efforts goes into effect.<sup>1</sup> It cannot be waived by the debtor, either before or during the case, since its purpose is not only to provide the debtor with a breathing spell but also to protect creditors that are less aggressive in their debt collection practices

than others. It is possible to have the court lift the stay, but a special motion is required.

Second, executory contracts may be assumed or rejected following the filing of the petition with the bankruptcy court.<sup>2</sup> An executory contract is a contract that is not yet complete. The Bankruptcy Code provides a debtor (or trustee in a Chapter 7 bankruptcy) time to assume (continue to perform) or reject (not perform) a particular contract. In the context of a construction project, any uncertainty as to whether a debtor subcontractor intends to (or is even able to) continue performance is likely to have a significant effect on the project's schedule.

Third, a debtor's assets as of the date of the bankruptcy petition become the debtor's property of the estate.<sup>3</sup> This may include progress payments received but not yet paid out by the debtor to potential lien claimants on the job. Or it may include progress payments (receivables) due to the debtor from the general contractor or owner. After filing a bankruptcy petition, the debtor may not pay its prepetition debts without court approval. As a result, trade creditors often wait months, even years, to be paid—if they are paid at all.

### Contract Provisions

Clearly, a bankruptcy filed by a subcontractor or a general contractor can severely delay a project, and no contract language will eliminate the cost and inconvenience. However, careful planning and drafting may minimize the time loss and expense of a bankruptcy.

An automatic stay extends to actions by an owner or general contractor to terminate an executory contract due to the debtor's default without first obtaining court approval. This is true even if the contract contains a nonassignability or bankruptcy default clause.<sup>4</sup> There is virtually nothing that can be done to avoid the impact of an automatic stay.

However, the specifier can take steps to accelerate certain elements of the bankruptcy process.

### Speeding Up Section 365 Elections

Section 365 of the Bankruptcy Code permits a bankruptcy trustee or a debtor-in-possession to assume or reject an executory contract. In a Chapter 7 liquidation, the trustee must assume the contract within 60 days of filing, or the contract is deemed rejected. In a Chapter 11 case, the debtor-in-possession is not constrained by a 60-day limit to assume or reject contracts but, in some circum-

Take steps to minimize  
bankruptcy delays.

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stances, may wait until confirmation of its Chapter 11.

If an executory contract is rejected, it is deemed to be in default, and the owner or general contractor may complete the scope of work itself or with a substitute contractor.<sup>5</sup> Often by the time a debtor or trustee rejects a contract, the contractor or owner has already encountered delays. Additionally, the substitution of a new contractor typically results in contract costs that exceed the original contract amount. Unfortunately, the only remedy available for the default (delay costs or additional completion costs) is an unsecured (and often worthless) claim in the debtor's bankruptcy case.<sup>6</sup>

If a debtor subcontractor intends to assume a contract, it must obtain court approval. Before assuming the contract, the debtor must "cure" any defaults in performance.<sup>7</sup> The general contractor or owner is also entitled to insist on "adequate assurances" that the debtor subcontractor can complete its work under the contract before the court will permit the assumption of the contract.<sup>8</sup> While the requirements of curing defaults and adequate assurances of future performance ability are beneficial, they are not particularly helpful when there has already been a significant delay in the assumption of the contract.

To minimize the damage, a general contractor or owner may make its own motion to require that the debtor subcontractor immediately elect to assume or reject the contract.<sup>9</sup> Because bankruptcy is designed to provide a breathing spell for a debtor, a motion by a general contractor to require a debtor to assume or reject a contract at an early stage in the bankruptcy will generally be viewed with disfavor by a bankruptcy court, unless it can be demonstrated that the debtor's immediate election is necessary to avoid prejudice to the general contractor or owner.

The urgency of a debtor subcontractor's immediate election may be addressed in the contract. In drafting contract terms, a general contractor or owner may include language in which the parties agree that due to the time sensitivity of the construc-

tion project, any delay in the debtor's election to assume or reject a contract after filing a bankruptcy petition will prejudice the general contractor or owner. The contract should also provide for the debtor subcontractor's agreement to waive the usual notice period for a motion to require the assumption or rejection of the contract.

#### **Progress Payments: Whose Funds Are They?**

When a general contractor or a subcontractor files a bankruptcy petition, the status of progress payments should be of concern to the owner. The progress payment is likely to be designated by the trustee as property of the debtor's estate.<sup>10</sup> If so, the funds will not be paid to the suppliers and laborers for the particular job on which the payment was made. Instead, the funds will be divided among *all* of the debtor's creditors.<sup>11</sup> Similarly, if a progress payment has not yet been paid to a debtor contractor, the trustee may seek a turnover order for the funds as property of the estate.<sup>12</sup>

To protect against the disruption of the progress payment pipelines, some state legislatures have enacted statutes that allow payments intended to flow to lower tier subcontractors, material suppliers, and laborers to be held in trust. However, some states, such as California, do not have statutory trust law for construction project payments. An owner or general contractor may, by artful drafting of contract language, designate progress payments made to (or due to) a subcontractor as funds held in trust for the benefit of appropriate claimants on a particular construction job to avoid distribution by a bankruptcy trustee in a contrary manner.

#### **Conclusion**

There are other potential areas of the bankruptcy process that can be anticipated and addressed in specifications. For example, on particularly complex jobs with specialized materials and products, language can be drafted to ensure that the goods are installed in a timely manner by a third party contractor, even if the supplier or installer of the goods or materials is in bankruptcy.

Filing for bankruptcy protection by a construction participant can convert a profitable job into an economic nightmare for an owner. It is essential that the specifier anticipate the delays of a bankruptcy and take proactive steps within the specifications to minimize the impact. ♦

#### **Notes**

1. 11 U.S.C. §362(a).
2. 11 U.S.C. §365(a).
3. 11 U.S.C. §541(a).
4. A clause that designates bankruptcy as a default under a subcontract is unenforceable.
5. 11 U.S.C. 365(g).
6. In certain cases, where retention is held or the debtor has claims for change orders, and where the contract includes a provision that permits a back-charge against payments due, these funds may be withheld by the contractor/owner under the equitable doctrine of recoupment. *In Re California Cannery and Growers* 62 B.R.18 (9th Cir. B.A.P. 1986).
7. 11 U.S.C. 365.
8. 11 U.S.C. 365(b)(1)(B) and (C).
9. Alternatively, the contractor can request that the debtor be required to reject the contract because the debtor subcontractor cannot cure the existing contract defaults or cannot provide the necessary assurances that it can complete the contract without further disruption.
10. The courts will look to state law to determine how to characterize the property. *Butner v. United States* (1979) 440 U.S. 48, 99 S.Ct. 914. In some states, these payments are the subject of statutory trusts, held for the benefit of debtor's creditors and are not estate property under 11 U.S.C. 541. In other states where there is no statutory trust, the status of the progress payments may be uncertain.
11. The money will be paid in accordance with the priorities as set forth in 11 U.S.C. §507 without regard to trade creditors with mechanic's lien rights against the owner.
12. 11 U.S.C. §541 permits a trustee to seek the turnover of estate property in possession of a third party.

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