

How to Handle a Bankruptcy Filing By an Owner or Subcontractor

Hinckley Allen Construction & Public Contracts

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Given the coming economic turbulence stemming from the COVID-19 pandemic, general contractors should be prepared with a plan of action in case a project owner or subcontractor files a bankruptcy petition. This article discusses two issues in that regard which are of particular importance to general contractors, namely Lien Law trust funds and bankruptcy preferences.

Lien Law Trust Funds

Article 3-A of the New York Lien Law creates a cascading system of trust funds on a construction project. If the owner borrows money to finance the construction, those borrowed funds are held by the owner as trustee for the benefit of the general contractor. The general contractor holds the payments he receives from the owner in trust for the benefit of the subcontractors, and so on down the line.

Trust funds are important to contractors because when a company or person files a bankruptcy petition, a bankruptcy estate is created that is comprised of the debtor's property. However, funds held as a trustee do not become part of the estate because, although the holder of trust funds has legal title to the funds, the equitable title to the funds is vested in the beneficiaries. The exclusion of trust funds from the bankruptcy estate is not automatic, and it is done only if a trust fund beneficiary makes a timely request of the Bankruptcy Court.

When an owner files a bankruptcy petition, and if the owner is using bank financing to fund the project, then the general contractor may have the right to ask the Bankruptcy Court to carve out the money owed to the general contractor from the bankruptcy estate because the money constitutes trust funds. In this situation, the general contractor is the trust fund beneficiary.

Conversely, when a subcontractor files a bankruptcy petition, the money that the general contractor would owe the subcontractor also constitutes trust funds. In this situation, the general contractor is the trust fund trustee. The concern for the trustee is that the beneficiaries of the trust may include: the subcontractor, the subcontractor's sub-subcontractors, material suppliers, workers, pension funds, the IRS and NYSDTF, among others. The way for a general contractor to protect itself when a subcontractor files is to make a motion in Bankruptcy Court for relief from the automatic stay, and then sue the subcontractor, and all the trust fund beneficiaries, as a defendant class in State Supreme Court under Section 77 of the Lien Law. In such a proceeding, the general contractor seeks an order from the court that declares the amount of the trust fund, who the beneficiaries are, the amounts they are entitled to on a modified pro-rata basis based on their priority, as well as a declaration that the general contractor has satisfied all of its obligations as a trustee. Without a court order, the problem is that, if a general contractor pays a trust fund claim that it knows about, other beneficiaries might later come out of the woodwork and demand payment of their trust fund claims, and thereby expose the general contractor to double liability.

Bankruptcy Preferences

The bankruptcy trustee can recover any payments that the bankrupt debtor paid within 90 days before filing for bankruptcy. This is frequently an issue for contractors when owners file. Bankruptcy trustees routinely send form letters demanding the return of the payments to all companies that the debtor has paid within 90 days before filing. If the money is not returned, the trustee typically sues in Bankruptcy Court for its return. Section 547 of the Bankruptcy Code broadly defines a preferential payment as any payment on account of an antecedent debt.

The way for a creditor to defeat a trustee's preference demand is by proving that the payments fall within one of the exceptions to the definition of a preference. The two most common exceptions are (1) payments made in the ordinary course of business, and (2) payments for new value. To prove that the payments were made in the ordinary course of business, the contractor must prove that the payments received from the owner within 90 days before the owner filed were of a similar size, speed, and otherwise similar to payments received from the owner before the 90-day period. The new value exception can be proved by demonstrating that the contractor provided a release of the owner's surety on the payment bond in an amount equal to the payment to the contractor.

Additional Notes

In addition to navigating the issues discussed above, a creditor of a bankruptcy estate should generally file a Notice of Claim with the Bankruptcy Court, stating the amount of the claim, noting whether it is secured or unsecured, and explaining the basis for the claim, including documentation supporting the claim. It is prudent for a creditor to consult with counsel to advise whether any portion of the claim may be considered secured, and to assist in properly assembling and filing a claim that will result in a statutory presumption of the creditor's entitlement to share in the proceeds of the estate.

In a bankruptcy case, short deadlines are the norm, and harsh consequences may result if a creditor does not act quickly to preserve its rights in Bankruptcy Court. If you have dealings with an owner, subcontractor, or other contractual party who has filed for bankruptcy, is about to file, or is in dire financial circumstances, it is prudent to consult early with counsel experienced with bankruptcy and creditors' rights to ensure that you preserve your rights.

We are here to help answer specific questions and offer advice on your options. Feel free to contact any member of our Construction & Public Contracts Group.

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