

# Spotlight On CORPORATE LAW

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## PLANNING FOR BANKRUPTCY: IF THE OWNER FAILS, WILL YOU SUCCEED?

*With the decline in the real estate market and the difficulty in obtaining funding from banks or other lending sources, more contractors may face the default or bankruptcy of a project owner. General contractors, subcontractors and others in the construction industry should be aware of strategies that may lessen the impact of a bankruptcy, and also the limits the Bankruptcy Code places on claims against an insolvent owner.*

**Negotiating a contract.** Diligent planning at the beginning of a project may reduce losses in the event of an Owner bankruptcy. When negotiating a contract, the general contractor and subcontractors should:

- Obtain evidence of financing from the Owner at the commencement of the contract, and include in the contract the right to obtain such evidence throughout the contract term;
- Obtain a commitment for direct payment from the lender to the contractor;
- For general contractors, include a “pay if paid” clause in all subcontract documents;
- Mechanics’ lien rights should not be restricted in any way, for example by waiving lien rights or requiring notice before a lien may be filed.

**Indications of a bankruptcy.** If an Owner suddenly delays payment, or pays less than the full amount due, questions should arise regarding the Owner and project financing. At this point, a contractor should:

- Evaluate project status and ensure that project accounting is current;
- Commence the mechanics’ lien process by filing a Notice of Contract;
- Minimize the amount of money advanced for equip-

ment or materials for the project, particularly if such items are specific to the struggling Owner’s project;

- Clearly mark any tools or materials that belong to the contractor but are located at the project site so that a bankruptcy trustee does not mistake them for the owner’s property;
- Scrutinize lien waivers to verify that the contractor is not releasing its lien rights with respect to any amounts other than those paid in full.

**Once the bankruptcy is filed.** Once a bankruptcy case commences, the Owner has the protection of the automatic stay, which protects the Owner from claims of contractors and other creditors while the Owner resolves its financial situation. The stay prevents actions that a contractor might otherwise take in the event of default, and the Bankruptcy Court may impose fines for willful violations of the stay.

The following are violations of the automatic stay, and once a bankruptcy commences, a general contractor cannot take these actions without prior Bankruptcy Court approval:

- Terminating the construction contract;
- Walking off the job;
- Demanding payment for past due sums;
- Changing the terms of the construction contract.

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### Bonds and Guaranties Outside Scope of Stay.

While the automatic stay prevents a contractor from pursuing an Owner for payment, the stay does not apply to non-debtors. If a payment bond has been issued with respect to a project, subcontractors may assert claims against the bond, because the surety is not protected by the stay. The subcontractor may need to seek relief from stay before proceeding against the bond, but the bond can provide a source of payment to subcontractors who are unable to collect from the Owner or general contractor. Further, if a contractor has a guaranty from the Owner's principal or parent corporation (a rare occurrence), the contractor may pursue payment from the guarantor (provided that the guarantor has not filed for bankruptcy).

**Rights of a Debtor.** The Bankruptcy Code provides certain rights that a bankrupt Owner would not otherwise have outside of a bankruptcy.

- The Owner may assume or reject a construction contract, meaning the Owner will decide whether to continue performing under the contract or stop its performance.



- The Owner has the right to assign the construction contract to a third party, and the general contractor in most cases would have to render performance to the assignee.
- Right to recover all payments (known as preferences) the debtor made to the creditor in the ninety (90) days before the bankruptcy filing. The Bankruptcy Code provides certain defenses to a preference demand, but contractors should be aware that all payments received 90 days before the bankruptcy filing are at risk of being returned to the Owner.

**Conclusion.** The current economy requires planning for the eventuality of an Owner bankruptcy. Understanding how bankruptcy

impacts a project will assist contractors in navigating the bankruptcy process. When entering into a construction contract, the parties should consider strategies for dealing with a bankruptcy, such as requiring a "pay if paid" provision or a letter of credit as security for payment. If a bankruptcy actually occurs, the case should be monitored to determine how the bankruptcy will impact the project and a contractor's own financial situation. ■

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