

Spotlight On CORPORATE LAW

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Managing Subcontractor Bankruptcies

The current economic conditions have had a particular impact on the construction industry. Private sector project owners have had difficulty obtaining financing, as public projects are placed on hold due to the decline in tax revenues. These economic difficulties increase the likelihood of subcontractor bankruptcies. Owners, developers and general contractors should consider the warning signs of a subcontractor bankruptcy and have a plan in effect for minimizing the losses that may result from a subcontractor bankruptcy filing.

Pre-Bankruptcy Considerations

Contract Provisions. The best defenses to a subcontractor bankruptcy are established when negotiating the subcontract and beginning the project. A general contractor should consider the following clauses in its subcontracts:

- Right of setoff for all jobs the subcontractor performs for the general contractor.
- Right to pay the subcontractor by joint checks at the sole discretion of the general contractor.
- Establish a form of periodic lien waiver to be used by the subcontractor that provides a detailed accounting of the progress on the project including payments made, retainage held, pending change orders and amount remaining to complete.

Joint Checks. If a contractor suspects that a lower tier subcontractor is in financial trouble, payment by joint check is a way to ensure that the troubled subcontractor uses the funds to pay its own subcontractors or suppliers on the job. If a check is payable to the subcontractor and supplier jointly, the subcontractor cannot cash the check without the supplier's signature. Otherwise, the general

contractor risks the subcontractor using the funds for other purposes, leaving the lower tier supplier or sub unpaid. The general contractor may then face lien or bond claims from the lower tier parties, forcing the general contractor to either pay twice for the same work to discharge the lien or breach its contract with the owner for having lien claims asserted against the project.

Lien Waivers. A detailed lien waiver provides a comprehensive snapshot of the subcontractor's project finances. By requiring a subcontractor to identify all its suppliers and lower-tier subcontractors, and then requiring signed lien waivers from all such parties each month as a condition to payment, the general contractor has some assurance that the payments made to date have been properly applied. If a subcontractor cannot provide a lien waiver from one of its suppliers, the general contractor can investigate the issue before making any further payments and catch a payment problem early. Failing to keep track of the progress of lower tier subcontractors on a monthly basis may cause financial losses for the general contractor if the struggling subcontractor uses payments from the general contractor for non-project expenses.

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The Bankruptcy Case

Chapter 7 compared to Chapter 11. A subcontractor may file a Chapter 7 bankruptcy, which means that it will no longer conduct business and will liquidate its assets. In a Chapter 7 case, the Bankruptcy Court appoints a Chapter 7 Trustee to take charge of the debtor's assets and settle its affairs. In a Chapter 11 bankruptcy, the subcontractor intends to continue its business operations while reorganizing its business. In most Chapter 11 cases, the debtor remains in control of its business and has authority to make ordinary business decisions without the involvement of a trustee.

Filing a Proof of Claim. A creditor asserts its claim against a debtor by filing a proof of claim that sets forth the amount owed to the creditor and the basis for the claim. Courts strictly enforce claim deadlines (known as "bar dates"), and creditors should diligently monitor the case deadlines and timely file the claim form.

Automatic Stay. As soon as the subcontractor files the bankruptcy petition, it has the protection of the automatic stay, which prevents anyone from taking action against the subcontractor. Violations of the stay include terminating the subcontractor, preventing the subcontractor from accessing the job site, and refusing to pay the subcontractor. A gen-

eral contractor should consult counsel before taking action against a subcontractor, because violations of the stay may result in monetary penalties against the general contractor.

Setoff Rights. A contractor or owner may receive a demand for payment from a debtor or trustee, even though the debtor caused significant losses by failing to complete its work prior to the bankruptcy filing. The right of setoff may provide a defense to paying the debtor. However, the creditor should have its invoices, payment records and other documentation in order to prove to the trustee (or to the Bankruptcy Court) that no more money is owed. Further, the automatic stay prevents a creditor from asserting setoff rights without Bankruptcy Court approval.

Conclusion

The bankruptcy of a subcontractor increases the possibility that a general contractor or owner may pay twice for a subcontractor's work, particularly if the subcontractor failed to use project funds to pay its own sub-subcontractors and suppliers. An owner or general contractor may reduce its exposure by anticipating a bankruptcy filing in the provisions of a subcontract and by requiring detailed project accounting throughout the project. ■

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