ProNet Practice Notes

Construction Contracts and Bankruptcy:
The Ultimate in "Value Engineering "

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- **Forward**
- **Construction Contracts and Bankruptcy: The Ultimate in "Value Engineering "**
- **How Bankruptcy Works**
- **Pending or Executory Contracts**
- **Perfect Your Mechanics' Lien Rights!**
- **The Automatic Stay**
- **Unauthorized or Preferential Transfers, or Having to Give Money Back to the Debtor**
- **Conclusion**
- **About The Author**

Forward

You have just learned that the other party to your contract has filed for bankruptcy. That party owes you money for past work and the project is not yet completed. This is a difficult and confusing situation that your firm might encounter. In this Practice Note, Jeremy W. Katz provides insight into the bankruptcy mechanism and the steps you might take to protect your firm's interests.

Construction Contracts and Bankruptcy: The Ultimate in "Value Engineering "

A prime designer or lead contractor on a design/build project files bankruptcy. Can a design professional/consultant working under contract to the entity filing for bankruptcy protection pack up its gear and walk off the job site or stop work? Can the consultant enforce its mechanics' lien rights against the real property's owner? Can the consultant look to the bankrupt's payment bond for payment? A bankruptcy filed by one party to a construction contract creates significant problems that put at risk the other party's right to payment. When this happens, the non-debtor party to the construction contract should be ready to act.

The construction business is a volatile one, and it makes little difference if times are good or bad. Prime contractors, consultants, subcontractors, and property owners are constantly filing for bankruptcy protection. They can be huge companies, such as Washington Group, International, Enron, and PG&E, or they can be small mom-and-pop operations. But no matter how large or small the bankruptcy, creditors are likely to suffer, because rarely are they paid in full. All bankruptcies have a ripple effect; the goal is to keep the waves as small as possible. In order to best protect its interests, the creditor should have some knowledge of creditors' rights and remedies. This knowledge allows the creditor to recognize, anticipate, and act upon issues that arise in a bankruptcy.

This article identifies some of the issues that arise when a bankruptcy is filed, as well as steps a design professional/consultant or subconsultant can take to protect its interests in the project contract. First, this article describes the bankruptcy process from a general standpoint. Second, it discusses specific issues related to the bankruptcy of owners and primes, whether they are design firms or contractors on a design-

build project. This article is not intended to be a comprehensive study of the topic, nor is it a substitute for a good bankruptcy lawyer. Its purpose is to allow a consultant to identify problems that may affect a construction contract when a bankruptcy is filed. This knowledge makes it more likely that the contractor will fare better than other creditors in the fight to be paid.

How Bankruptcy Works
An Overview

Bankruptcy is governed by federal law. The purpose of the bankruptcy laws is to treat all similarly-situated creditors equally, so that one does not receive more favorable treatment than another. This is accomplished either through a plan of reorganization, where the debtor's business continues to operate, or through a liquidation, where a bankruptcy trustee collects and liquidates assets to distribute to creditors pursuant to the priorities set forth in the Bankruptcy Code.

Although there are several kinds of bankruptcies, the two most common involving real property owners and contractors are Chapter 11 reorganization and Chapter 7 liquidation. The goal of a Chapter 11 reorganization is to give a debtor breathing room so it can reorganize its financial affairs and return to viability and profitability. The goal of a Chapter 7 liquidation is to marshal and turn into cash a debtor's assets, from which creditors are paid. In general, creditors fair better when the debtor is in a Chapter 11 than in a Chapter 7 because the debtor wants to continue doing business with its creditors. This happens only if the creditors get paid.

A bankruptcy is usually commenced by the debtor filing a petition, schedules of assets and liabilities, statement of the debtor's financial affairs, and paying a filing fee. When the bankruptcy petition is filed, an order for relief is entered, which imposes and puts on hold all actions against the debtor to collect debts. The "automatic stay " also prohibits any action that might adversely affect property of the bankruptcy estate. For example, if the debtor is the owner of the project site, a creditor cannot record a mechanics' lien or foreclose on a mechanics' lien. However, the automatic stay does not apply to non-debtor guarantors (such as sureties), to whom a creditor can look for payment.

Upon the filing of the bankruptcy petition, an "estate" is created, which consists of all the debtor's property. It is from this property that creditors are paid. An estate's property includes among other things, real and personal property, accounts receivable, intellectual property, licenses, royalties, claims against others, purchase options, insurance policies, and uncompleted construction contracts.

In a Chapter 7 bankruptcy, the debtor does not reorganize. The debtor turns over all non-exempt assets to a bankruptcy trustee, whose job it is to marshal and liquidate the assets. From the trustee's efforts, creditors are paid according to a hierarchical scheme: secured creditors (those with legal rights to a particular asset) receive their collateral or the proceeds of its sale; administrative expenses (amounts owed to court-approved lawyers, accountants, and other professionals who provided services after the bankruptcy was filed) receive payment next; then pre-petition wage claims are paid; then pre-petition priority taxes are paid; and then general unsecured creditors (vendors, consultants and other professionals who performed services prior to the bankruptcy but were not paid, personal injury claimants, and credit card companies, none of which had legal rights to specific assets) are paid. If property of the estate remains available after paying these creditors in full, shareholders are paid. Of course, rarely do general unsecured creditors receive full payment.

In a Chapter 11 bankruptcy, the debtor intends to continue to operate its business under bankruptcy court supervision. Once it files its bankruptcy petition, the debtor becomes a "debtor-in-possession" (also called a "DIP"), because it remains in possession of its assets and business. A trustee is not appointed unless the court finds that the DIP is not acting properly. A creditors' committee is usually formed by the largest unsecured creditors, for the purpose of monitoring the business post-petition and negotiating a plan of reorganization with the DIP. The plan of reorganization must be approved by the bankruptcy court to become effective. If a consensual plan cannot be achieved, then the DIP will seek confirmation of the plan over the creditor s' objection. If the debtor's plan is not approved, a creditor or a creditors' committee can file its own plan of reorganization for the debtor, and seek court approval of that plan. In most instances, if a plan is not eventually approved, the bankruptcy judge will likely convert the case to a Chapter 7 liquidation.

Once a plan is confirmed, it becomes a new contract between the DIP and its creditors, and supersedes all prior contracts. The DIP is now referred to as the "Reorganized Debtor. " The plan usually calls for payments to unsecured creditors over several years, and also provides for remedies if the Reorganized Debtor fails to make those payments. Unfortunately, rare is the case of a plan being completed. Most Chapter 11 reorganizations fail because the business simply cannot sustain itself. Consequently, most Chapter 11 bankruptcies convert to a Chapter 7 liquidation, and creditors frequently fare worse in a converted Chapter 11 than they would have if the case had initially been filed as a Chapter 7.

In order to participate in any distribution, a creditor, as a general rule, must file a proof of claim by a specified date, called the "Bar Date." The claim represents the pre-petition debt owed by the debtor to the creditor and could include contingent claims such as delay damages on an as yet uncompleted project. Usually, a proof of claim form is provided to creditors by the bankruptcy court. However, they can be found on many web sites, including some web sites posted by local bankruptcy courts. A properly filed proof of claim is prima facie evidence of the validity of that claim, which means that the claim is allowed for distribution purposes, unless the bankruptcy trustee or DIP objects to it. To be properly filed, the proof of claim form must be correctly completed, signed under penalty of perjury, and accompanied by all supporting documentation. Once the Bar Date has passed, a creditor cannot without great difficulty assert a claim for pre-petition debts.

A claim is classified as either secured, administrative, priority unsecured, or general unsecured. A secured claim is a claim that is secured by collateral or a lien against specific real or personal property. Perhaps the most common example of a secured claim is the mortgage against one's residence. In the construction context, a consultant's claim is secured if the debt is secured by a perfected mechanics' lien against real property. A priority claim is an unsecured claim for certain unpaid wages and benefits up to a maximum of $4,650.00 per claimant, certain consumer deposits, alimony and support, and certain taxes. A general unsecured claim is everything not secured or priority. Trade debt, such as unpaid fees for professional services or money owed to a material supplier, is a common example of a general unsecured claim.

Pending or Executory Contracts

When a Chapter 11 reorganization is filed, the debtor-in-possession cannot pay creditors the pre-petition amounts it owes under its contracts without a court order or a confirmed plan of reorganization. A plan of reorganization is usually not confirmed for a year or more. This prohibition can cause an acute financial strain on consultants or subconsultants, who may be owed hundreds of thousands of dollars when the debtor files bankruptcy. The consultant cannot just pack up and leave the job site without risking a

lawsuit, because doing so jeopardizes the value of the debtor's contract, which is an asset of the bankruptcy estate. This is true even if the contract provides that the contract is terminated if a bankruptcy is filed. Bankruptcy termination clauses are not enforceable. Thus, a consultant must first get bankruptcy court approval before it can stop working.

Construction contracts are "executory contracts." The Bankruptcy Code permits a bankruptcy trustee or debtor-in-possession to assume or reject an executory contract. A debtor-in-possession has until the confirmation of a plan of reorganization (which may be many months or even years later) to decide if it will assume or reject an executory contract, unless the other party to the contract requests that the bankruptcy court compel the debtor-in-possession to decide sooner. In any event, the court is likely to give a debtor-in-possession a fair amount of time, since decisions regarding assumption or rejection can have a major financial impact on the debtor's reorganization.

The Bankruptcy Code does not define the term "executory." The definition generally accepted by the bankruptcy courts is "[a] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. " There has been much litigation over the meaning of this definition, but most contracts are executory contracts.

Executory contracts are important in a bankruptcy case because they can be either a significant asset or a significant liability. As a general proposition, if the contract has value to the estate, it will be assumed. (However, certain executory contracts cannot be assumed. They are not discussed in this article.) If it represents a liability to the estate, it will be rejected. Generally the Bankruptcy Court must approve any assumption or rejection of an executory contract. In the Chapter 7 liquidation context, it is highly unlikely that a bankruptcy trustee will assume a construction contract. Chances are that the debtor has already defaulted on the contract pre-bankruptcy, and the other party to the contract has setoff rights against the amounts owed to the bankruptcy estate. A Chapter 7 bankruptcy trustee is not likely to have either the forces or the financial ability to complete any unfinished work. Consequently, the other party to the construction contract will have to hire someone else to complete the job, usually at a cost much higher than the original contract price. Under these circumstances, there is no monetary benefit to the bankruptcy trustee in assuming the construction contract.

The decision to assume or reject an executory contract can have significant repercussions for the bankruptcy trustee or debtor-in-possession. If the contract is rejected, the bankruptcy estate loses any benefits it had under the contract, and is liable for all damages caused by the rejection, which is considered a breach of contract. However, the Bankruptcy Code provides that any damages caused by the rejection of an executory contract are treated as a pre-petition, general unsecured claim. If the contract is assumed, the bankruptcy estate retains the benefits it has under the contract, but also assumes all of the liabilities it has under the contract. In order to assume the contract, the bankruptcy trustee or debtor-in-possession must cure all pre-bankruptcy defaults, and continue with its performance. If the trustee or debtor-in-possession defaults under the contract after assuming it, the resulting damages become an expense of administration, with a priority higher than prepetition claims.

Perfect Your Mechanics' Lien Rights!

Mechanics' liens protect consultants, contractors, material suppliers, and equipment lessors from non-payment for goods or services, and if properly perfected, elevate to secured status their claims for

payment when the owner of the real property files bankruptcy. Mechanics' lien laws are very technical, and lien rights can be lost if the consultant does not comply precisely with the mechanic's lien statutes.

Every state grants those contributing to a private work of improvement rights to a mechanics' lien. The mechanics' lien gives them a statutory lien against real property on which the consultant, contractor, material supplier, or equipment lessor has furnished materials or labor. A mechanics' lien gives the lienholder the right to foreclose. The amount of the lien is the value of the materials or labor furnished.

In addition to the standard mechanics' lien rights that apply to projects under construction, in some states, design professionals also have statutory liens to ensure payment for their services prior to the commencement of construction. The lien is for the amount of the design professional's fee for any services rendered prior to commencement of the work of improvement or the reasonable value of those services, whichever is less. Design professionals' liens are enforced the same way as are mechanic s' liens. Again, this is a technical area, and the design professional should consult with an attorney who has experience with construction and lien laws.

Some consultants consider it "unprofessional" to file mechanics' liens on projects, and therefore, place themselves at a disadvantage relative to other creditors when they are not paid. Contractors seem to have no problem asserting their rights, and therefore, are often in a superior position, particularly when a bankruptcy is filed.

The Automatic Stay

As previously mentioned, the filing of a bankruptcy petition immediately imposes the automatic stay provisions of Bankruptcy Code § 362(a), which stops collection efforts and foreclosure actions, and prevents creditors from satisfying their claims at the expense of other creditors. Thus, if a consultant files a bankruptcy petition, the subconsultant cannot demand payment for pre-bankruptcy services, file a lawsuit, or enforce a judgment obtained prior to the bankruptcy filing. If a property owner files bankruptcy, a consultant or subconsultant cannot demand payment for pre-bankruptcy services or goods, record a mechanics' lien, or foreclose a mechanics' lien.

The automatic stay does not stop or prevent the creditor from pursuing non-debtor third parties. Thus, consultants and subconsultants can take steps to collect against a guarantor of the debtor's obligation. Consequently, where a project is bonded, a subconsultant owed money by a bonded contractor generally can seek payment from a surety bond issued by a third party to guarantee the contractor's performance of its contracts. This is because the bond is not property of the estate, since the bond is for the benefit of third party beneficiaries of the bond. However, before taking action against the surety, a creditor should confirm that the jurisdiction in which the bankruptcy is filed considers surety bonds as non-estate property.

Fortunately, consultants and subconsultants are not without a remedy when a bankruptcy is filed. If the creditor has taken all necessary and proper steps up to the time that the bankruptcy is filed, that creditor can file a Notice of Perfection or a Notice of Continuation of Perfection under Bankruptcy Code § 546(b), which operates to protect the creditor's lien rights. Thus, if, when the bankruptcy is filed, the time to record a mechanics' lien or to commence an action to foreclose a mechanics' lien has not yet expired, the filing of the appropriate notice with the bankruptcy court preserves the creditor's lien rights.

The automatic stay does not prevent collection actions against property that is not property of the estate. This means that if a prime consultant or contractor files bankruptcy, the subconsultant may proceed with the foreclosure on a mechanic's lien against an owner's real property, because the real property is not property of the bankruptcy estate. Nevertheless, if the debtor can make a showing that the foreclosure will adversely affect its ability to reorganize, a judge can enjoin the foreclosure.

Unauthorized or Preferential Transfers, or Having to Give Money Back to the Debtor

The Bankruptcy Code permits a trustee (and a Chapter 11 debtor-in-possession) to recover, for the benefit of all creditors, certain payments made by the debtor to specific creditors. The two most common examples of these payments are unauthorized post-petition transfers and preferential transfers.

Bankruptcy Code § 549 allows a trustee to avoid a transfer made by a debtor post-bankruptcy that is not made in the ordinary course of business, is not authorized by the Bankruptcy Code, or is not authorized by a bankruptcy judge. The term "transfer " is broadly construed and includes payment for goods delivered or services rendered. The grant of a security for a debt is also a "transfer. "

In a Chapter 11 reorganization, a debtor-in-possession cannot pay consultants for pre-petition work performed or supplies delivered, unless the payment is made pursuant to a confirmed plan of reorganization, or the contract is assumed. In certain circumstances, a debtor-in-possession will seek bankruptcy court approval to permit it to pay pre-petition obligations to "critical vendors, " whom the debtor-in-possession believes are vital to the debtor's reorganization and continued operation. Otherwise, the debtor will argue that the vendors will refuse to do further work for the debtor, jeopardizing its ability to complete projects or successfully bid new work.

If payment is made by check, the "transfer" occurs when the bank honors the check. Therefore, it is good practice to deposit checks as soon as they are received. If the payor is in financial difficulty, waiting to deposit the check may result in the check clearing after the bankruptcy is filed. The trustee may then get the payment back.

Another statute commonly employed by a trustee to bring assets into the bankruptcy estate is Bankruptcy Code § 547, which permits a trustee to avoid any "preferential" payment. The payment is called "preferential " because one creditor is "preferred " over other creditors. In practical terms, a preference is a payment made to a creditor by the debtor outside the ordinary course of business within ninety days before the filing of the bankruptcy. Thus, if the consultant receives payment on past-due invoices, or takes any collection efforts to obtain payment, those payments may have to be given back to the trustee.

In order to recover an avoidable transfer, a trustee must file a lawsuit, called an "adversary proceeding, " in the bankruptcy court. The lawsuit is initiated by the filing of a complaint, and the summons and complaint are then served on the defendant. In bankruptcy court, unlike in state or federal district courts, service of the summons and complaint is effectuated by mailing them to the defendant by first class mail. A trustee does not have to have the defendant personally served. Consequently, if you receive any legal papers in the mail from a bankruptcy trustee or debtor-inpossession, do not ignore them, but contact a bankruptcy attorney. Otherwise, you may be out of luck.

In the general trade-debt context, one of the ways to avoid receiving an avoidable transfer is to require payment by C.O.D. or cashier's check for services performed or goods delivered. These methods of payment are not considered preferential, but rather contemporaneous exchanges, which are immune from recovery by a trustee.

When dealing with a construction contract, one way to possibly avoid a demand for payment from a trustee is to require joint checks. If the other party on the joint check files bankruptcy, the non-bankrupt party may convince the bankruptcy judge that the entire payment was "earmarked, " that is, intended for, the non-debtor party, and not for the debtor. The payment, then, does not include any of the debtor's property, and cannot constitute an avoidable transfer.

If a consultant releases a mechanics' lien in exchange for payment, there is no avoidable transfer, provided that the debtor owns the real property against which the lien has attached, and there is equity in the real property. The transfer in not avoidable because the debtor is receiving "new value " for the payment in the form of the lien release, which gives the debtor more equity in the real property. However, it is an open question as to whether the release of a right to perfect a mechanics' lien insulates the creditor from a preference action.

A mechanics' lien that has been properly perfected within the preference period cannot be attacked as a preferential transfer because the creation of a statutory lien is not a preference. Consequently, a consultant or subconsultant should consider recording the mechanics' lien as soon as possible, even if it is likely to be within ninety days of the bankruptcy. Recording the mechanics' lien is good business. A mechanics' lien cannot be a preference, but it can be an unauthorized post-petition transfer. And the creditor will have a secured claim in the bankruptcy case.

Conclusion

A bankruptcy filed by an owner, consultant, contractor, or subcontractor creates numerous problems, many of which are highly technical in nature. When the creditor receives notice, or becomes aware, that a bankruptcy has been filed, the creditor must immediately stop any collection activity. The consultant should not walk off the job site without first obtaining relief from the automatic stay to terminate the construction contract, or obtaining an order from the bankruptcy court compelling the debtor to assume or reject the construction contract. If the debtor assumes it, the debtor must pay the consultant all arrearages. If the debtor rejects the construction contract, the consultant can stop work without fear of breaching the contract. Claims deadlines are rigid and inflexible and the failure to meet them can jeopardize your right to any payment. For these reasons, when a party to an ongoing construction project becomes involved in a bankruptcy case, you really do need to consult your local bankruptcy attorney.

About The Author

Jeremy W. Katz heads the Creditors' Rights and Insolvency Group at the law firm of Gordon & Rees LLP in San Francisco, California. He represents creditors and debtors in business work outs, in Chapter 11 reorganizations, and in Chapter 7 liquidations. He also represents bankruptcy trustees. Mr. Katz obtained his law degree from the University of California, Hastings College of Law, in 1985. He received his Bachelor of Arts degree from University of California, Berkeley, and holds a Master of Arts degree from the University of Michigan.