When major projects fail, news articles report on the downfall of once-premier developers, construction companies, and even owners of marquis projects. The economic downturn has been equally, if not more, difficult for smaller companies that may not have the resources needed to survive.

Unfortunately, the slow pace of economic recovery portends more stalled projects and additional bankruptcy filings that CFMs must guard against. The federal sequester and continued gridlock in Washington, D.C. will not help.

These and other negative influences will almost certainly increase the bankruptcy risk of contractors and material suppliers, particularly those that rely on government work for significant percentages of revenue. How and to what extent these factors will impact the broader construction industry is yet to be determined. However, bankruptcy filings from all corners of the industry are expected to increase through 2013 and beyond.

It is essential that, as a CFM, you understand the consequences of a bankruptcy filing and are prepared to protect your company’s bottom line. This article addresses several pertinent bankruptcy issues and suggests procedures to plan for and respond to bankruptcy filings by companies within a project’s contractual hierarchy.

**Key Bankruptcy Law Concepts**

Under the federal Bankruptcy Code, corporations typically have two options when commencing a voluntary bankruptcy proceeding: Chapter 7, Liquidation or Chapter 11, Reorganization.

**Chapter 7 vs. Chapter 11**

Under Chapter 7, the debtor’s business operations cease and a bankruptcy trustee is appointed to collect and sell all of the debtor’s assets quickly and for the highest possible price. Once the assets are sold, frequently through auction, creditors receive payment in the following priority:

1) Creditors with valid and enforceable liens on specific debtor assets;
2) Persons or entities that incurred expenses to administer the
Chapter 7 case (e.g., bankruptcy trustee and lawyers who represent the bankrupt estate); and

3) General unsecured creditors receive pro-rata payments relative to amounts owed from the remaining estate balance – if any.

If general unsecured creditors receive any payment, it is typically only a percentage of their outstanding debts because there are rarely sufficient assets to pay the debtor’s general unsecured obligations in full. (Strategies for contractors and subcontractors to obtain more favorable status as secured creditors will be discussed later.)

If a corporation believes it can restructure its operations such that it can both remain a going concern and pay its creditors amounts greater than they would receive through a liquidation proceeding under Chapter 7, then it may seek to reorganize under Chapter 11.

Reorganization rests on the theory that even a corporation that is unable to satisfy its current obligations may be worth more than the sum of its assets following a restructuring of its business. A bankruptcy court must agree that reorganization is appropriate by confirming the debtor’s plan of reorganization. A reorganization plan must address how the debtor will continue to conduct its business and how it will satisfy the claims of secured and unsecured creditors.

The debtor typically files its plan of reorganization with the bankruptcy court after negotiating with its creditors, who frequently agree to accept reduced payment of their debts or participate in the bankruptcy case to object to their treatment under the debtor’s proposed reorganization plan.

CFMs should carefully review a project debtor’s proposed reorganization plan because it will have a profound impact on not only existing debts, but also the rights and obligations of project participants and often the construction project itself.

It is critical that CFMs understand and assess their companies’ relative economic positions both prior to and after a debtor seeks bankruptcy protection. In many cases, agreements to reduce debts and allow owners or upper- and lower-tier contractors to avoid filing bankruptcy and complete projects will result in a more advantageous financial outcome. The same is true when negotiating with a debtor seeking to reorganize.

The ability to understand and predict your company’s anticipated repayment following a Chapter 7 liquidation proceeding is necessary to properly assess a Chapter 11 debtor’s reorganization plan. If you believe your company would receive greater repayment under Chapter 7, then you may wish to object to the reorganization plan or request that the bankruptcy court require a modified plan that provides more advantageous terms to your company and others of equal status.

The Bankruptcy Petition & Estate

The petition date is the date a debtor files its initial court petition seeking protection under Chapter 7 or Chapter 11 of the federal Bankruptcy Code. This date is significant because your company’s options in dealing with troubled contractors, subcontractors, or owners before and after they file a bankruptcy petition change dramatically.

Immediately upon filing the petition, all of the debtor’s assets are assumed by its “bankruptcy estate.” Depending on whether the debtor is seeking to liquidate or reorganize, the estate is administered by a bankruptcy trustee appointed by either the bankruptcy court or the debtor itself, which is now referred to as a “debtor in possession.”

The bankruptcy estate is a separate legal entity that assumes control over “all legal or equitable interests of the debtor” as of the petition date. These interests include contracts with owners, subcontractors, and material suppliers, all of which will be greatly impacted by the bankruptcy filing.

The Automatic Stay

An equally important consequence of a bankruptcy filing is the “automatic stay” of all collection or enforcement proceedings against the debtor. After the petition is filed, creditors are prohibited from engaging in a number of activities directed at the debtor or property of the bankruptcy estate, including collection activities and the unilateral termination of contracts.

Regardless of your company’s notice of a bankruptcy petition, any actions it takes in violation of the automatic stay are void. The prohibition against terminating contracts, even if substantial defaults exist, is of particular concern in the construction context. For example, absent appropriate planning, a contractor cannot quickly replace a bankrupt subcontractor or supplier despite delay and other negative financial impacts to the project. Similarly, a GC may risk defaulting by ceasing performance, even if continuing work increases the unsecured debt of an owner with a deteriorating financial position.

Even if a construction contract expressly provides for termination upon the filing of a bankruptcy petition, contractors must still obtain approval from the bankruptcy court before validly terminating a subcontract. Unfortunately, that
approval often occurs months after the request – and after the project has experienced significant delay.

**Rejection or Assumption of Executory Contracts**

A related feature of the automatic stay is the trustee or debtor in possession’s right to assume or reject “executory,” or incomplete, contracts.4

Depending on the nature of the bankruptcy case, the debtor or trustee must assume or reject contracts within 60 or 120 days. The bankruptcy court must approve assumption (which is frequently coupled with a request to assign the assumed contract) and rejection of executory contracts.

Unfortunately for creditors, bankruptcy courts almost never grant relief from the automatic stay and allow contractors to terminate a construction contract or subcontract during the period the debtor is entitled to assume or reject the contract. If the debtor or trustee does not expressly reject the construction contract during this period, then contractors must petition the bankruptcy court for authorization to terminate the contract, subcontract, or purchase order.

The Bankruptcy Code does provide protection to contractors in the event owners or subcontractors operating under bankruptcy protection choose to assume their existing contracts.

For example, a bankrupt subcontractor (or sub-subcontractor or material supplier) may only assume a contract if it provides the upper-tier contractor with adequate assurance that it will promptly cure any existing defaults under the subcontract, including prompt payment of any expenses associated with prior defaults under the subcontract.5 The bankrupt subcontractor must also provide assurances that it will be able to perform all of its future obligations under the subcontract.6

Ultimately, the bankruptcy court rules on the adequacy of the debtor’s assurances and determines whether the requirements for assumption of executory contracts are present. Debtors often seek the consent to assume executory contracts from the other contracting party, which can be filed with and approved by the bankruptcy court in the form of an assumption stipulation. Assumption stipulations with lower-tier contractors or material suppliers should require:

- That the debtor provide a detailed schedule of all work and timing of work to be performed under the assumed contract;
- That the upper-tier contractor/creditor is permitted to pay the debtor and all of its subcontractors and material suppliers by joint check;
- The right to immediately terminate the subcontract without further involvement of the bankruptcy court if the subcontractor is unable to meet its obligations;
- The right to replace the subcontractor on the project if contract obligations are not met; and
- The right to set off any damages or expenses caused by the debtor’s further breach against any funds that may be due under the subcontract or otherwise.

Contractors should seek similar protections in owner-requested assumption stipulations as well as the right to receive information concerning project financing or other funding. Depending on the circumstances, other terms and protections should be considered before entering into a stipulation for approval by the bankruptcy court.

**Voidable Preferences**

A “voidable preference” is intended to place all unsecured creditors on equal footing following a bankruptcy. The preference right is typically exercised by a bankruptcy trustee who administers a liquidation proceeding. The trustee is entitled to recover, or “claw back,” payments made by the debtor within 90 days of the petition date that provided the receiving party more than they would have received through the bankruptcy process.7 The requirement that a party receives “more” is nearly always met because unsecured creditors rarely receive full payment of their debts through bankruptcy proceedings.

Actions by a bankruptcy trustee to recover preferential contractor payments are of particular concern because subcontractors and material suppliers will undoubtedly look upstream for payment of clawed back amounts through the exercise of lien rights, threats to stop work, or both.

**Maximize Your Company’s Options**

Clearly, recognizing and responding to a party’s deteriorating financial situation before a bankruptcy filing is critical to maximizing your company’s options and limiting harm to the project. This entails a number of factors, including recognizing and avoiding risky subcontractors and owners, closely monitoring performance and payment practices following contract or subcontract award, and negotiating contract terms that allow you to assess the subcontractor and suppliers’ financial positions and supplement their work in the event of bankruptcy.

Of course, there is no substitute for obtaining payment and performance bonds. Unlike actions against a bankrupt contractor or owner, proceedings to require sureties to fulfill bond obligations are not subject to the Bankruptcy Code’s automatic stay.
Assuming the lack of bonds, contractors concerned that an owner or subcontractor is headed toward bankruptcy should carefully weigh the pros and cons of terminating the contract before it files a bankruptcy petition. The status of the work and the terms of the construction contract affect this decision, as well as consideration of concessions or financial support to attempt to complete the project before a bankruptcy filing.

When making these assessments, knowledge really is power. Contract terms that allow your company access to owner and subcontractor financial statements and information (such as cash on hand, A/P, and current bonding capacity) are helpful tools contractors and subcontractors can use to more accurately assess the risk of bankruptcy and take appropriate responsive action.

Contractors and subcontractors should also attempt to negotiate contract terms that allow them to furnish any or all of lower-tier contractors or suppliers’ defined scope through others. In the event termination is unavailable due to a subcontractor or supplier bankruptcy petition, terms to this effect are invaluable to progress the project using a replacement contractor or supplier because there is no need to terminate the contract to allow completion of the bankrupt entity’s scope.

Construction companies should consider similar terms that allow direct payment to subcontractors and vendors, and provide subcontractors and vendors a security interest in payments made to contractors or subcontractors for their goods or services. The right to direct payments also increases control over downstream parties’ financial situation and provides some additional flexibility if subcontractors and vendors will ultimately be directed by a replacement contractor or contract manager.

Providing subcontractors and vendors a security interest in payments significantly increases the likelihood they will be deemed “secured creditors,” which are not subject to a bankruptcy trustee’s preference claims and therefore unlikely to assert payment claims against upper-tier contractors or liens against the project.\(^8\)

Finally, in addition to strictly conditioning payment on the provision of subcontractor and vendor lien waivers, GCs with the obligation to bond off liens should consider adding language to required lien waivers that expressly acknowledges the waivers are final and binding despite claims asserted by any person or entity including a bankruptcy trustee.

**Conclusion**

The bankruptcy of any party is never good news for a construction project. Appropriate contract clauses can lessen, but not completely avoid, associated delays and project costs. In addition to negotiating favorable terms, CFMs and their advisors must carefully weigh the anticipated costs and risks associated with a pre-petition termination and replacement against those their companies expect to incur due to project delays and payment claims following a Chapter 7 or Chapter 11 bankruptcy proceeding.

Endnotes:

1. 11 USC §541(a)(1).
2. 11 USC §365, 541.
3. 11 USC §362(a).
4. 11 USC §365(a).
5. Id.
6. Id.
7. 11 USC §547(b).
8. 11 USC §547(b)(5).

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