

Bulletin #86, Getting Paid in the Event of a General Contractor Bankruptcy (May 17, 2005)

What should a subcontractor do after he/she has signed a contract, started construction, furnished materials, and the general contractor then files for bankruptcy? The general contractor owes the subcontractor money for past work and the project is not yet completed. What are the subcontractor's remedies and options?

Construction contracts present unique problems in bankruptcy. This is true because the contracts involve the rights and obligations of at least three separate categories of persons: owners, general contractors, and subcontractors. There are a variety of cost-effective actions to minimize the impact of a general contractor bankruptcy on a subcontractor. However, the remedies available to the subcontractor against a general contractor are limited due to the imposition of the "automatic stay," which protects parties filing bankruptcy from collection while the bankruptcy is being administered by the court (discussed below).

A bankruptcy filed by a general contractor jeopardizes a subcontractor's right to payment. When this happens, the subcontractor should be ready to act. This *Contracts Bulletin* provides insight into bankruptcy and presents the steps that a subcontractor might take to protect its interests.

General Overview of Bankruptcy

The Bankruptcy Code is a set of federal laws designed to accomplish several ends. First, to protect the financially distressed debtor from the actions of overzealous and frustrated creditors. Second, to protect **all** creditors of the debtor – i.e., to treat "equally" all creditors of the debtor similarly situated. Third, to afford the debtor relief and release from overburdening debt and allow the debtor a "fresh start." Bankruptcy law was borne of economic reality and economic necessity, tempered with public policy.

The two most common types of bankruptcies for owners, contractors, and subcontractors are Chapter 7 (liquidation) and Chapter 11 (reorganization).

Chapter 7 Liquidation

In a Chapter 7 liquidation, the debtor's purpose is to obtain discharge (i.e., cancellation) of its debts. The debtor turns over to a Bankruptcy Trustee (an individual appointed by the Bankruptcy Court to administer the debtor's assets and liabilities) all of its non-exempt property, which the Trustee sells or otherwise converts to cash. The Trustee distributes the cash among the debtor's creditors. The debtor keeps its exempt property (for example, a home, retirement accounts, and personal household items) and once discharge from bankruptcy is obtained, the debtor is able to "start afresh." A debtor's former creditors

cannot pursue the debtor on the old debts, as they are deemed to no longer exist, even though the creditors receive very little or nothing from the Trustee's liquidation and distribution of the debtor's non-exempt property.

The Bankruptcy Trustee liquidates assets to pay creditors according to the rules set forth in the Bankruptcy Code. Creditors are paid (to the extent of available assets) in the following order: (1) secured creditors (those with legal rights in a particular asset) receive their collateral or the proceeds from the sale of their collateral; (2) administrative expenses (amounts owed to court-approved professionals and others who provided services after the bankruptcy was filed) receive payment; (3) other priority claims (i.e., employees' wages and employee benefits, taxes) are paid; and (4) general unsecured creditors (subcontractors, suppliers, and others who performed services or provided goods prior to the bankruptcy but were not paid, personal injury claimants, and credit card companies) are paid.

Chapter 11 Reorganization

In a Chapter 11 reorganization, the debtor's business continues to operate. Upon filing a bankruptcy petition, the debtor becomes a "debtor-in-possession" (DIP), because it remains in possession of its assets and business. The debtor tries to pay the creditors at least a portion of the debts owed over a period of time. A written plan for the retirement of the debts is required to be filed and approved by a vote of the creditors or the Bankruptcy Court. Once a repayment plan is confirmed, it supersedes all prior contracts, becoming a new contract between the DIP and its creditors. The DIP usually makes payment from earned income and/or from the liquidation of its assets. Chapter 11 reorganization gives a debtor "breathing space" so it can reorganize its financial affairs and, hopefully, return to viability and profitability. Creditors tend to fair better when the debtor is in a Chapter 11 rather than in a Chapter 7 bankruptcy because the debtor wants to continue doing business with its creditors. However, a Chapter 11 reorganization plan is rarely completed because often times the business simply cannot sustain itself. If a Chapter 11 fails, the bankruptcy is generally "converted to a Chapter 7" and follows the liquidation procedure discussed above.

Commencement of Bankruptcy

A bankruptcy is started by filing a petition. The petition can either be filed voluntarily by the debtor or involuntarily by the creditors. The filing of a bankruptcy petition automatically "stays" (restrains) further collection efforts or lien enforcement by creditors and "breathing space" is afforded to the debtor. The automatic "stay" bars commencement or continuation of any proceeding against the debtor and prohibits any actions to obtain possession of property of the debtor's estate (the estate is comprised of "all legal or equitable interests of the debtor in property" at the time of filing). The automatic "stay" also prevents perfection or enforcement of liens against the property of the debtor.

A bankruptcy petition filed by a general contractor will undoubtedly prevent the subcontractor from suing the general contractor to recover unpaid amounts. The subcontractor cannot demand payment for pre-bankruptcy services, file a lawsuit, or enforce a judgment once a bankruptcy has been filed. However, the automatic stay does not stop or prevent a creditor (such as a subcontractor) from pursuing other parties who are not in bankruptcy. Thus, a subcontractor can take steps to collect against any parties who have guaranteed the general contractor's (debtor's) debt. For example, when a project is bonded, a subcontractor that is owed money by a bonded general contractor can seek payment from a surety bond issued by a third party to guarantee the general contractor's performance of its contract because the bond is for the benefit of third party beneficiaries of the bond. Likewise, any guarantors of the debtor's debt, who have not filed bankruptcy, can also be pursued by creditors.

Having to Give Money Back to the Debtor

The Bankruptcy Code permits a Trustee (and a Chapter 11 DIP) to recover certain payments or transfers made by the debtor to creditors. When payments or transfers are recovered, the property belongs to the debtor's bankruptcy estate. The two most common examples of these payments are preferential transfers and unauthorized post-petition transfers.

A preferential transfer is a pre-bankruptcy transaction, occurring on the “eve of bankruptcy” that results in more favorable treatment of a creditor over other similar creditors. Bankruptcy law and policy requires equal treatment of similarly situated creditors, so the Trustee is authorized to avoid certain “preferential transfers.” In practical terms, a “preferential transfer” is a payment on an outstanding debt made to a creditor (e.g., a subcontractor) by the debtor (e.g., the general contractor) outside the ordinary course of business and within 90 days of the filing of the bankruptcy allowing the creditor to receive more than other similarly situated creditors were able to receive. For example, the general contractor normally pays on the first of the month and always keeps a ten percent retainage. Then, after not having kept current with its payment obligations and right before filing bankruptcy, the general contractor makes a “catch-up” payment to the subcontractor. The Bankruptcy Code allows a Trustee to recover this “preferential” payment.

An unauthorized post-petition transfer is a transfer made by a debtor after the debtor’s bankruptcy filing that is not authorized by the Bankruptcy Code. The Bankruptcy Code allows a Trustee to invalidate and recover such a transfer. In order to recover the invalidated or avoidable transfer, a Trustee must file a lawsuit, called an “adversary proceeding,” in the bankruptcy court within a specified time (usually two years after the Trustee is appointed).

Additionally, (as discussed in detail below under “Use of Joint Payee Checks”) when dealing with a construction contract, one way to possibly avoid a demand for payment from a Trustee is to require joint checks.

Subcontractors’ Remedies

A bankruptcy filed by a general contractor creates numerous problems, many of which are highly technical in nature. Fortunately, subcontractors may not be without a remedy when a bankruptcy is filed.

Mechanic’s and Materialmen’s Lien

A mechanic’s lien can be a very useful tool in the event that a general contractor files for bankruptcy. Owners and the subcontractors who hold mechanic’s liens are the individuals most entitled to the full satisfaction of their claims.

Although statutes vary greatly from state to state, all states grant contractors, subcontractors, suppliers, and others the right to have their unpaid bills satisfied out of the real property that was improved by their labor or materials. A mechanic’s or materialmen’s lien can be very valuable to a subcontractor or supplier because the “automatic stay” will not bar the subcontractor from suing a non-debtor third party (e.g., an owner of property whose property was improved as a result of the subcontractor’s work) to enforce its lien rights.

Mechanic’s lien laws are very technical and lien rights can be lost if the subcontractor or supplier does not comply precisely with the mechanic’s lien statutes. For example, creation and perfection of a mechanic’s lien almost always require the public filing or recording of some notice of the lien claim within a fixed period of time following completion of the work or provision of the materials. Additionally, it is also often necessary to personally serve the property owner and sometimes the general contractor and other parties with a notice of the lien and demand for payment.

Other Approaches to Receive Payment

Another way for a subcontractor to protect its payment rights, in the event that the general contractor files for bankruptcy, is establishing an interest in contract proceeds due from an owner. The subcontractor may claim that the funds due to the debtor-general contractor never became property of the bankruptcy estate because payment was due direct to the subcontractor. This contention will generally be based on one or more of the following theories.

Trust Funds’ Statutes

If the contract between the subcontractor and the general contractor is governed by the law of a state that provides for a statutory trust, then the subcontractor will likely be able to recover payment immediately from the general contractor, despite the pending bankruptcy. Statutory trusts (also known as a builders' trust fund or construction trust fund for the benefit of owners, subcontractors, materialmen, and laborers) are created by state law and several states have enacted statutes providing for the creation of such trusts. The basic concept of construction trust fund statutes is that construction contract proceeds owed or paid to a general contractor and intended to cover a subcontractor or supplier's work are deemed to be held in trust for the benefit of the subcontractor or supplier. However, some state funds have limits on the amount that may be recovered from a state fund.

Express Trusts

Even if a subcontractor is not in a state that has enacted a construction trust fund statute, it may be able to recover payment immediately from the general contractor in bankruptcy if the subcontractor negotiated an express trust in its contract with the general contractor. The parties contractually create a "trust fund" to ensure that the subcontractor receives payment in the event the general contractor fails to pay its debts to the subcontractor. In such event, the proceeds in the "trust fund" are not part of the debtor/general contractor's bankruptcy estate. For an express trust to arise, generally the trust must possess the following general characteristics: (1) explicit declaration of trust; (2) clearly defined trust property; and (3) an intent to create a trust. See, e.g., In re Mason, 191 B.R. 50, 55 (Bankr. S.D.N.Y. 1996); In re Englund, 20 B.R. 957, 961 (Bankr. E.D. Mich. 1982). Some jurisdictions also require that the express trust be evidenced by a written agreement or technical instrument and/or that the express trust have identifiable beneficiaries and trustees.

However, courts are divided over whether a subcontractor can successfully use an express trust to lay claim to funds owed to him by a general contractor. Thus, the subcontractor must carefully examine the treatment of such trusts in its applicable state.

Constructive Trusts

A subcontractor may also attempt to recover payment from the general contractor in bankruptcy, ahead of other creditors, by use of a constructive trust. A subcontractor may petition the court to recognize an equitable lien and impose a constructive trust on such funds for the benefit of unpaid laborers and materialmen. A bankruptcy court will generally impose a constructive trust for the benefit of a subcontractor in two circumstances: (1) to avoid unjust enrichment of one party at the expense of another party, which provides labor and supplies for a construction project, and (2) to compel restitution of property that in equity and good conscience does not belong to a party. First Commercial Corp. v. First Nat. Bancorporation, Inc., 572 F.Supp. 1430, 1435 (D.Colo. 1983); In re Foos, 183 B.R. 149, 158 (Bankr. N.D.Ill. 1995). However, it must be noted that this technique has been met with relatively little success.

Use of Joint Payee Checks

In some instances, a subcontractor may arrange to have the contractor's customer (ordinarily the owner for whom the work is performed) make payment with a joint payee check. As discussed above, if the contractor files bankruptcy within ninety days of endorsing the check over to the subcontractor, an issue arises over whether the transfer of funds is recoverable by the Trustee or DIP as a preferential transfer. The issue is whether this is a payment made to the subcontractor by the owner or to the debtor (the general contractor) and, thus, part of the bankruptcy estate. Most courts rule that joint check payments, which include the subcontractor, are **not** payments permitting recovery of the check by the Bankruptcy Trustee, because the payment was "earmarked" (intended for) the subcontractor and not the debtor. Therefore, the payment does not include any of the general contractor's property and cannot constitute a transfer that can be avoided.

Bonds

Payment bonds serve the same basic purpose as mechanic's lien statutes; namely, to provide protection for subcontractors against the deficiencies and insolvency of the general contractor. On a private project, a payment bond will ordinarily be provided by the general contractor for the benefit of the property owner. However, most courts have had little conceptual difficulty in allowing subcontractors to enforce the bond directly against the surety company under a third-party beneficiary theory. Thus a subcontractor can use a surety bond to get paid even if the general contractor files bankruptcy.

Restitution Claim

Many jurisdictions have statutes, which permit criminal and civil actions against general contractors who fail to forward payments from owners to pay subcontractors. See e.g. Minn. Stat. § 514.02. In these situations, subcontractors are sometimes able to have general contractors prosecuted in a criminal action. Criminal "restitution" (a/k/a "damages") can be awarded to a harmed party like a subcontractor. Awards of criminal restitution are non-dischargeable in bankruptcy; put another way, a general contractor cannot use bankruptcy to escape liability to a subcontractor. The presence of these statutes creates substantial leverage for subcontractors where general contractors fail to forward payments from owners intended for subcontractors.

Conclusion

The bankruptcy of a general contractor is an unwelcome event for all. The fate of subcontractors seeking to recover uncollected debts from general contractors filing bankruptcy depends largely on the laws of the state in which the dispute arises. There are mechanisms that a subcontractor can use in order to protect its payment rights in the event of bankruptcy. The specific problems facing parties to construction contracts in bankruptcy cover a wide and complex range of bankruptcy principles. For these reasons, when a party to a construction project becomes involved in a bankruptcy case, it is important to consult a bankruptcy attorney. Nevertheless, careful planning (i.e., obtaining surety bonds or joint payees on owner's checks) and swift action (filing mechanic's liens) can help minimize a subcontractor's exposure.

(This article contains a general discussion of the law. You should consult with your attorney on the issues regarding bankruptcy. This article does not constitute and should not be treated as legal advice as to any particular situation.)

SMACNA members are encouraged to submit any comments on this topic to Tom Soles, SMACNA's Executive Director – Market Sectors, (e-mail: tsoles@smacna.org; telephone: 703 803 2988) or Steve Yoch (e-mail: syoch@felhaber.com; telephone 651 312 6040).

Sheet Metal and Air Conditioning Contractors' National Association
4201 Lafayette Center Drive Chantilly, Virginia 20151-1209
Tel (703) 803-2980 Fax (703) 803-3732 info@smacna.org



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