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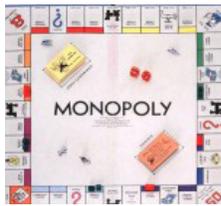
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But The Owner Still Owes Me Money!

What To Do When A Private Project Owner Files For Bankruptcy



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In the Parker Brothers' famous Monopoly game, if a player goes bankrupt he sells all his houses and hotels back to the bank, then mortgages all of his property; if he still can't pay the rent on Park Place with two hotels, he forfeits his cash and its game-over. In the real world of construction, if a private owner declares bankruptcy, a complicated mess unfolds regarding who gets paid what, from what assets, timing and the future of the construction project. However, just like in Monopoly, a well-planned strategy may get you paid before the owner rides Reading Railroad right out of the game.

It has happened before and it will certainly happen again – the owner gets behind on processing payments. You do have immediate recourse, although the specific steps and timing may vary from state to state. First, if your state requires it, serve the owner and, if applicable, the construction lender, with a preliminary notice. If the owner fails to pay, then record a mechanic's lien against the property (be sure to actually record this at the county recorder's office – although in some states the lien must be filed and served on the owner, merely serving this form on the owner is meaningless if it's not recorded.) If that still doesn't get you a walk on the Boardwalk, then it's time to file a lawsuit to force the

sale of the property (e.g. foreclose on the lien.) But what happens if – before, after or during any of those steps – the owner files for bankruptcy? Let's roll the dice, "Pass Go," and see if we can collect our \$200.



Owner insolvency is a growing problem in the construction industry. The economic downturn wreaked havoc on premier owners and developers. Changes in the real estate market attracted boutique developers, some of whom are unfamiliar or unprepared for the financial burden of funding a construction development project all the way to completion. When an owner files for bankruptcy, project completion is delayed and the contractors' ability to get paid for finalized work is seriously jeopardized. However, with a little help from the Community Chest, there are a few tools you can utilize to protect mechanic's lien rights, possibly complete the contract, and increase your chances of getting paid on the Project.

Bankruptcy Overview

As soon as an owner files for bankruptcy, all of its assets are assumed by the "bankruptcy estate." Depending on what chapter the owner files, the estate is administered by either the bankruptcy trustee, or the owner itself, as a "debtor in possession." From here on out, the bankruptcy estate, a separate legal entity, assumes control of all legal and equitable interests of the bankrupt owner, including construction contracts, projects and financing.



There are generally two main alternatives when an owner voluntarily files for bankruptcy: Chapter 7 – Liquidation, or Chapter 11 – Reorganization. In a Chapter 7 bankruptcy, the owner ceases business completely, a bankruptcy trustee is appointed to collect and sell the debtor’s assets, which are then used to pay the debtor’s creditors based upon priority. Chapter 11 bankruptcy allows the debtor to restructure its business operations by submitting a “Reorganization Plan” to the Bankruptcy Court outlining how and when it can satisfy its current financial obligations. As a creditor, a contractor owed money by the bankrupt owner may object to the Reorganization Plan; however, the Bankruptcy Court has the final say in approving or rejecting the debtor’s restructuring.

Regardless of the chapter the owner files, the concept of priority is universal. There are three types of bankruptcy creditors: priority, secured, and unsecured. Priority claims are paid first and include tax obligations, child support, and alimony. Secured creditors are second in line, holding a security interest in an asset of the bankruptcy estate (e.g. a lien on real property.) In the event the security has value exceeding all liens and encumbrances, secured creditors are paid next. Finally, as their name implies, unsecured creditors do not hold a security interest in any property of the estate (e.g. breach of contract claimants). Unsecured creditors are paid last, on a pro rata basis of whatever residue is left in the bankruptcy estate. The harsh reality is that unsecured claims, if paid, are generally afforded pennies on the dollar.

Automatic Stay



As soon as the owner files for bankruptcy, the Bankruptcy Court sends out a Notice of Commencement of Case and issues an Automatic Stay. The notice informs all creditors that the owner has filed for bankruptcy protection. The Automatic Stay halts all collection or enforcement activities against the owner. Collection or enforcement activities include beginning or continuing litigation, any efforts to collect money, or unilaterally terminating or enforcing a contract. Collection or enforcement activities do not include recording a mechanic’s lien or serving a bonded stop payment notice on the construction lender. At this

point, if you have not yet recorded your mechanic’s lien, you should do so immediately, and consider serving a bonded stop payment notice on the construction lender.

If you have already filed a lawsuit to foreclose on your lien, this action is also paused by the Automatic Stay and all proceedings cease until the Automatic Stay is lifted, the bankruptcy is dismissed, or the property securing the mechanic’s lien is abandoned. If you have not yet filed a lawsuit to foreclose, the Automatic Stay prohibits you from filing suit at this time.

Proof of Claim

In order for the Bankruptcy Court to properly assess the debtor’s financial situation, it needs to know exactly how much money the owner owes and to whom. As such, once you receive notice of commencement of the case, you should immediately file a Proof of Claim. A Proof of Claim informs the Bankruptcy Court of how much you are owed. If, when the owner files its bankruptcy petition, you do not receive a notice of any court filings. These will alert you when the Automatic Stay is lifted, the case is dismissed, the debt is discharged, or if the property securing your lien has been abandoned.

Notice of Continued Perfection

When the owner files for bankruptcy, if you have not yet filed your lawsuit, the Bankruptcy Court allows you to file a Notice of Continued Perfection. Since the Automatic Stay halts all collection and enforcement activities, including enforcing your mechanic’s lien rights, this notice tolls the deadline to file suit to foreclose on the lien. Then, in the event the bankruptcy trustee abandons your security, or the bankruptcy case is dismissed (not discharged) or the automatic stay lifted, you can proceed to enforce your mechanic’s lien rights at that time.

If there is any concern that the property securing your lien might decrease in value, your priority position might erode, or the owner lacks sufficient equity in the secured property, you might consider asking the Bankruptcy Court for relief from the automatic stay to allow you to file or continue to pursue a lawsuit to foreclose on the mechanic’s lien.



Executory Contracts

Many construction contracts provide that the filing of bankruptcy by either contracting party constitutes a material breach of the agreement,

entitling the non-breaching party to rescind the contract. Although common, these types ipso facto contract clauses are generally unenforceable. Indeed, not only does the Automatic Stay prevent collection efforts against the owner, it also prohibits the unilateral termination of contracts. What does this mean for contractors? Bad news. Even though the owner isn't paying you and filed for bankruptcy, you might still have to continue performance under the contract. Partially performed construction contracts are considered "executory contracts." Depending on the chapter, and subject to the Bankruptcy Court's approval, either the debtor-in-possession or the trustee will decide whether or not to accept or reject an executory contract.

The good news however, is that if the debtor (in a Chapter 11) or the trustee (in a Chapter 7) accept your contract as an executory contract, the bankruptcy estate becomes bound to honor the contract. All amounts owed under the contract are generally re-categorized as administrative expenses and are entitled to full payment. Moreover, the estate must cure all outstanding monetary defaults and provide assurances for future performance. The estate may also assign the contract to a third party. Contract terms restricting the assignability of the contract are generally unenforceable in these circumstances. However, if the contract is assigned to a third party, adequate assurances of future performance must be provided by the third-party assignee.

On the flipside, if the debtor or trustee rejects the construction contract then the bankruptcy estate is in breach of the contract and is liable for all damages. Recall however, that breach of contract damages are unsecured claims and at the end of the day, will not likely result in much recovery.

Conclusion

You don't need a Chance card to tell you that a bankrupt construction owner is worse than being elected chairman of the board and having to pay each player 50 bucks. Although a bankruptcy does not automatically negate mechanic's lien rights, it certainly complicate things. Understanding the process and the tools available to protect your rights, and might just get you paid more on the project than, say, winning second prize in a beauty contest.

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Christine Barker is a senior counsel with the Construction practice group in the Orange County office. Ms. Barker is a highly accomplished attorney with significant experience in general and complex matters with an emphasis in construction litigation. She also has experience in commercial litigation and employment law. Ms. Barker represents owners, developers, subcontractors and design professionals, in all aspects of litigation including, creating and implementing discovery plans and trial strategy, filing and defending against mechanic's liens and stop notices, evaluating and resolving defect and delay claims, making resolution recommendations, and effectively representing her clients at Mediation, Binding Arbitration, Settlement Conference and Trial. Ms. Barker counsels her clients in drafting and negotiating construction contracts, bid documents and protests, change order requests and navigating the workings of the California Subcontractor Listing Laws.