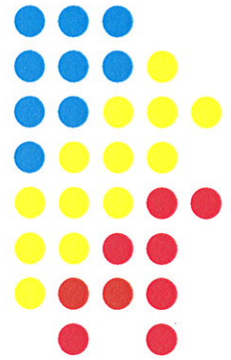


THE CONTRACTOR'S



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# Legally Speaking



## Customer Bankruptcy What's a Subcontractor to Do?

*by Jay Clark, Esq., and Larry Logsdon, Esq.*

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## **Customer Bankruptcy! What's a Subcontractor to Do?**

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**B**ankruptcies are on the rise and the construction industry is feeling the effects just like other industries. This article discusses some key challenges that subcontractors will want to manage in case of a general contractor's (or other customer's) bankruptcy.

### **Chapter 7 and Chapter 11 — What's the Difference?**

Most general contractors are corporations, partnerships or limited liability companies, which are eligible to file only a Chapter 7 or a Chapter 11 proceeding under the U.S. Bankruptcy Code (the Code). In a Chapter 7 case, an appointed bankruptcy trustee will take control of the debtor's assets, liquidate them and divide the proceeds among the debtor's creditors. In a Chapter 11 case, however, the debtor will have an opportunity to reorganize and attempt to stay in business. The management of a Chapter 11 debtor will usually retain control of the decision-making of the company throughout the bankruptcy process. You may hear the term "debtor-in-possession" in such cases. It means exactly what it says: The debtor, not a trustee, remains in possession and control of the assets and management of the company.

### **'Automatic Stay' Stops Collections Against Debtor**

Upon filing of a bankruptcy petition, an "automatic stay" immediately protects the debtor. For example, a stay would prohibit a subcontractor from commencing or continuing any

activity to collect on debts that a general contractor owed for work performed before the general contractor filed the bankruptcy case. The stay would suspend any lawsuit or collection action that was pending. It would also prevent enforcement of a prior judgment. The subcontractor would have to cease demands for payment in person, by phone, by letter, etc. An "automatic stay" is analogous to a referee blowing the whistle and stopping a play just when the tacklers are ready to pounce on the quarterback. If a bankruptcy court determined that a creditor willfully violated a stay, it could fine the creditor for that conduct. Subcontractors should take great care not to give a wounded debtor "ammunition" to strike back at them, by violating an automatic stay.

### **Pursue Lien or Bond Claims**

Although a stay would alter a subcontractor's normal collection routine, it would not stop it from pursuing collection efforts against a third party that was not in bankruptcy, such as a lien claim against a project owner or a bond claim against a surety. The Code specifically allows efforts to perfect a lien to continue. If time allows, filing a motion with the bankruptcy court requesting permission, or relief from the stay, to proceed is advisable nonetheless. The steps to perfect a lien vary from state to state, but in states requiring a lawsuit to perfect the lien, a subcontractor would need to file a motion with the bankruptcy court before filing any lawsuit against the debtor.





Bond claims, like lien claims, have mandatory deadlines, so subcontractors should focus on meeting bond claim requirements in case of a customer bankruptcy. Knowing the deadline to file a notice of claim and the deadline for filing a lawsuit is key. The bond's terms — or, for state or federal public projects, the terms in the applicable statutes — describe the rules for filing a bond claim. For example, the federal Miller Act governs bond claims on federal and federally funded jobs, requiring a subcontractor to provide a notice of a claim within 90 days of completing its work. Subcontractors handling a bankruptcy on this type of project should consult with their attorneys to ensure that they will meet, despite the automatic stay's restrictions, the Miller Act's requirement for filing a lawsuit within one year of performing work or supplying materials.

## Working through the requirements of the bankruptcy may be challenging, but that's because the process is intended to protect both debtors and creditors.

### File Your Claim with Bankruptcy Court

Separately from any lien or bond claim, a subcontractor should file an official notice of its claim (or "proof of claim") in a bankruptcy case. A subcontractor's "proof of claim" tells the bankruptcy court how much the debtor owed the subcontractor on the day the bankruptcy case was filed. In every Chapter 11 case, the court will establish a deadline to file such proofs. For a subcontractor to be included in any forthcoming distribution of payments, it must (with limited exceptions) file its proof of claim form before the deadline with the appropriate clerk of the bankruptcy court in which the case was filed. Filing the claim does not ensure the subcontractor will be paid in full, or at all; but failing to file by the deadline usually will remove any chance of receiving payment. The debtor's plan in a Chapter 11 case will outline how much it intends to repay its creditors. In many Chapter 7 cases, the debtor has no assets to liquidate — there may not even be a claim deadline! If there are assets and a subcontractor files a claim, payments under a Chapter 7 case will depend upon the amount available to distribute and the size of the subcontractor's claim relative to other creditors' claims.

If a subcontractor still has work to perform under its contract with a debtor, it may want to file a motion in the bankruptcy court to ask the trustee, or the debtor-in-possession, to either "assume" or "reject" the contract. If the work that remains is critical for project completion, the trustee or debtor-in-possession may decide to assume, or continue with, the subcontractor's contract. To do so, it must cure all past defaults and agree to perform under the contract in a timely manner. If the trustee or debtor-in-possession rejects the contract, the subcontractor is no longer obligated to perform the balance of work and is entitled to file a claim for damages resulting from the rejected contract. The subcontractor's claim for such damages would be separate from the proof of claim for amounts owed to it at the time of bankruptcy filing.

### Protect Against Customer Bankruptcy Before It Happens

One way for a subcontractor to address questions it has about a customer's financial stability is to ask the project owner to make payments with joint payee checks. Using joint payee

checks may help the subcontractor keep payments it received just before a customer's bankruptcy filing from being recovered by other creditors as a "preference." In general, the amounts that a debtor pays within 90 days before filing for bankruptcy are

subject to forfeiture if the payments show a "preference" for, or favor, one creditor over the others. A joint payee check provides some defense against such a "preference" claim. Another safeguard for subcontractors is simply to use judgment and weigh their risk at the bidding stage. A subcontractor should weigh anticipated profits versus customers' potential failure to pay. Other factors, such as the existence of a payment bond, may change a subcontractor's decision on whether to bid a project. Even when there's a bond, it's always a good idea to confirm its purchase instead of

simply relying on a customer's representation. Plus, obtaining a copy of the bond before starting work will provide information that a subcontractor will need to file a claim, should the need arise.

### Your Attorney Should Be Knowledgeable About Bankruptcy

Before the need presents itself — typically on the eve of a critical deadline — find an attorney who is knowledgeable about bankruptcy. Ask your own attorney or your ASA chapter attorney for a referral. Notify the bankruptcy attorney right away when you learn of a bankruptcy filing connected to one of your projects. No matter how much or little you are owed, you'll need assistance with possible preference claims and filing a proof of claim. The bottom line is that a knowledgeable attorney will help you identify and gather the information you'll need to minimize loss and increase recovery.

### Conclusion

The bankruptcy of a general contractor or other customer is never welcome news. Working through the requirements of the bankruptcy may be challenging, but that's because the process is intended to protect both debtors and creditors. As soon as you learn of a bankruptcy filing, you should suspend further collection efforts and move swiftly to protect your payment rights, as provided by the Code and other statutes. The odds of receiving everything you want from a bankruptcy case may be low, but if you do nothing, the odds plummet to zero every time. ■

*Jay H. Clark, Esq., and Larry Logsdon, Esq., are partners in the law firm of Wallace, Jordan, Ratliff & Brandt LLC ([www.wallacejordan.com](http://www.wallacejordan.com)), Birmingham, Ala. They can be reached at [jclark@wallacejordan.com](mailto:jclark@wallacejordan.com) and [llogsdon@wallacejordan.com](mailto:llogsdon@wallacejordan.com).*

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