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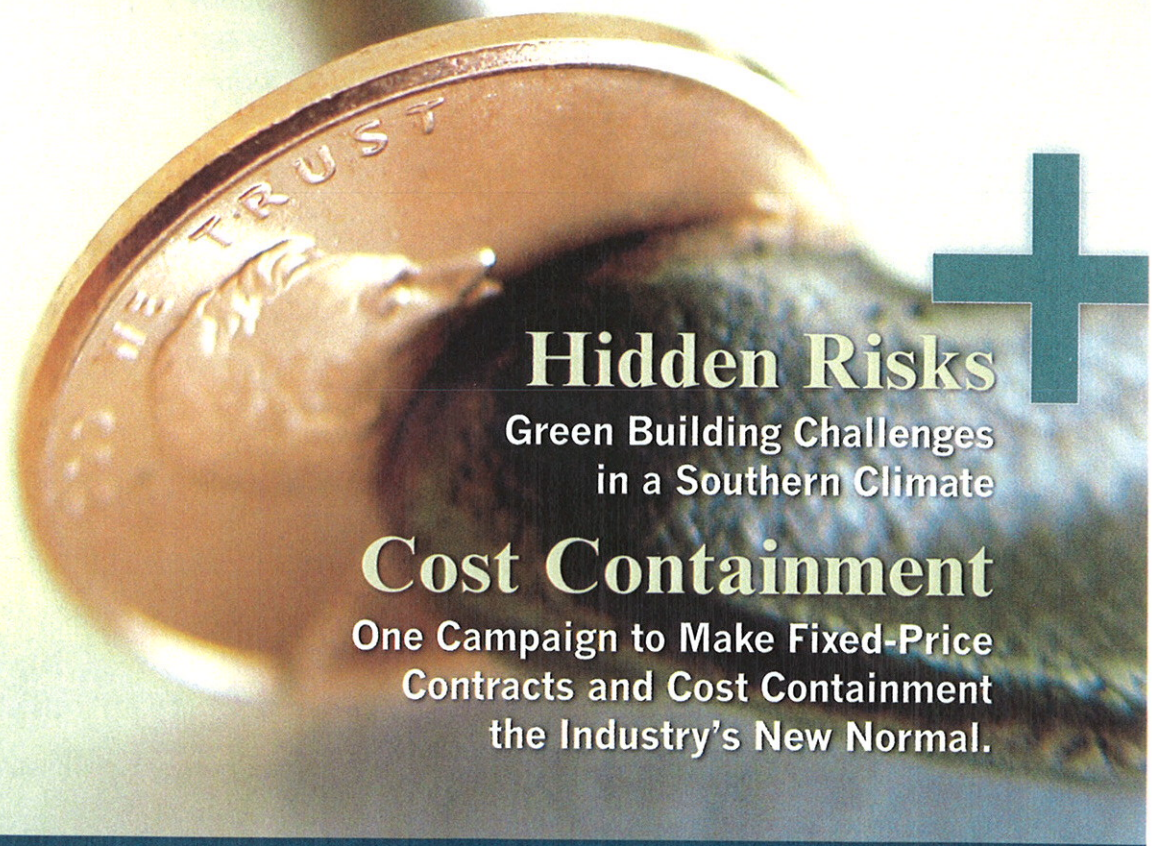

Hidden Risks

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Cost Containment

One Campaign to Make Fixed-Price Contracts and Cost Containment the Industry's New Normal.

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SPOTLIGHT: HUNTSVILLE/TENNESSEE VALLEY

by **Jay Clark** and **Larry S. Logsdon**
of Wallace, Jordan Ratliff & Brandt, L.L.C.

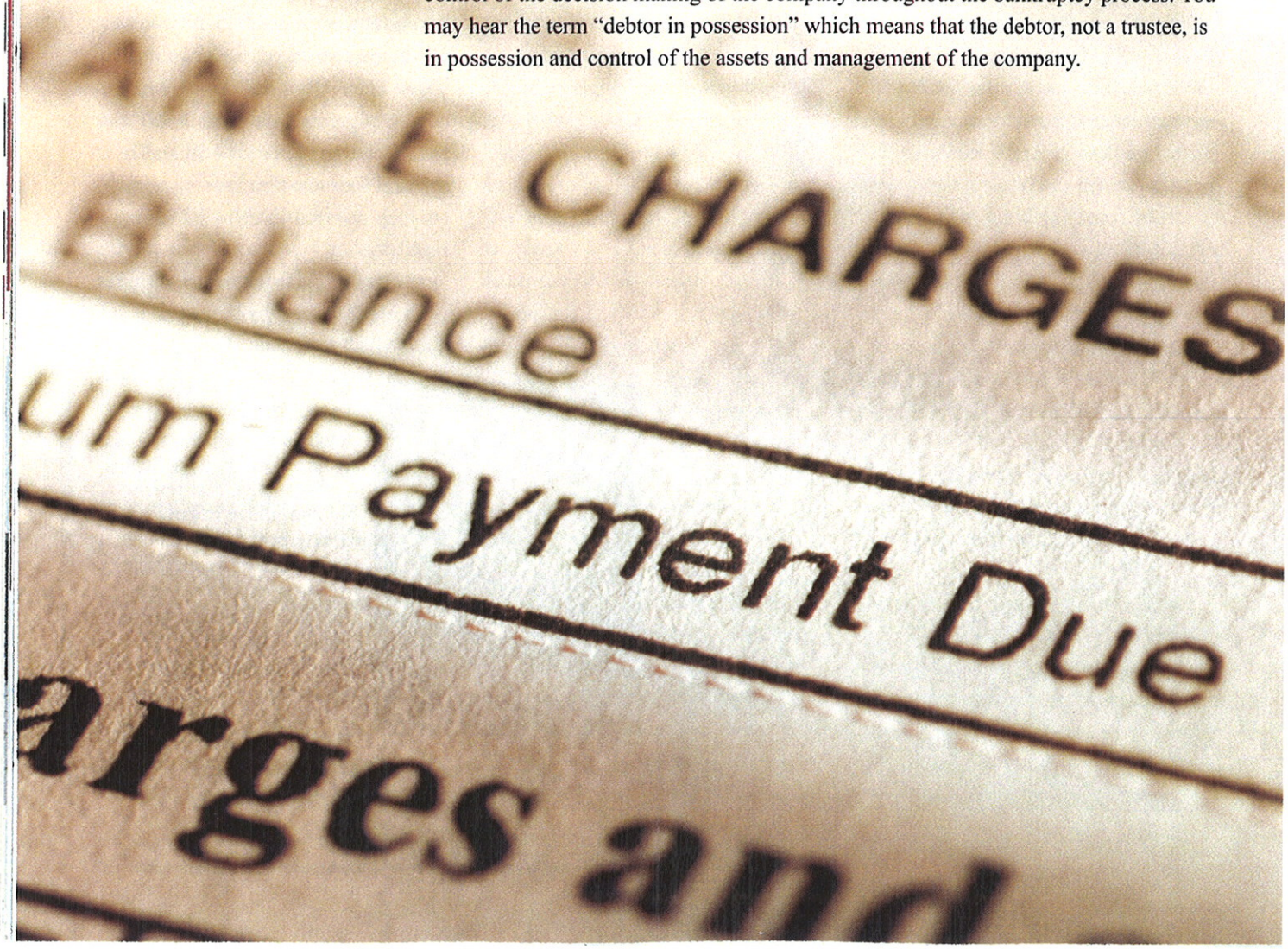
The B-Word

WHAT'S A CONTRACTOR TO DO? Bankruptcies are on the rise and the construction industry is feeling the effects. This article will discuss some important things to consider when you first hear the news that your general contractor or customer has filed bankruptcy.

What is the difference between Chapter 7 and Chapter 11?

Corporations, partnerships, and limited liability companies are only eligible to file a Chapter 7 or Chapter 11 proceeding under the United States Bankruptcy Code (the "Code"). Most general contractors will fall into one of these three categories.

Under Chapter 7, the debtor will cease to exist once the bankruptcy case is concluded. In Chapter 7, a bankruptcy trustee will be appointed to take control of the debtor's assets, liquidate them, and divide the proceeds among the debtor's creditors. A Chapter 11 case is designed to allow the debtor an opportunity to reorganize the company in an effort to stay in business. The management of the 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" which means that the debtor, not a trustee, is in possession and control of the assets and management of the company.



How does the "automatic stay" restrict the contractor?

Upon filing of the bankruptcy petition, the debtor is immediately protected by an "automatic stay." The automatic stay prohibits you from commencing or continuing all activity against the debtor to collect on debts owed for work performed before filing of the bankruptcy case. This means that any lawsuit or collection action that is pending is suspended. The stay also prevents enforcement of a prior judgment. Even demands for payment in person, by phone, or by letter should cease because of the stay. The "automatic stay" is analogous to the referee blowing the whistle and stopping the play just when the tacklers are ready to pounce on the quarterback.


Jay Clark

If the bankruptcy court determines that you willfully violated the stay you can be fined for that conduct. Great care should be taken not to violate the automatic stay and give the wounded debtor ammunition to strike back at you, its creditor.

Will bankruptcy wipe out my lien claim or void the project bond?

Although the stay may alter your normal collection routine, it may not stop you from pursuing your collection efforts against a third party that is not in bankruptcy, such as a lien claim against the owner or a bond claim against the project insurer. The Code specifically allows for the continuation of efforts to perfect a lien, but if time allows it is always advisable to file a motion with the bankruptcy court requesting permission (or relief from the stay) to proceed. Steps to perfect a lien vary from state to state but if your state also requires a lawsuit to perfect, you will need to file a motion with the bankruptcy court before filing any lawsuit against the debtor. It is best to go ahead and seek court permission for the entire lien process before proceeding.

The rules regarding filing bond claims can be governed by the terms of the bond and whether a state or federal project is involved. Because of the automatic stay, perhaps the most important issues in dealing with a debtor are those dealing with the timing of when notice of the claim and the lawsuit must be filed. For example, bond claims on federal jobs are governed by the Miller Act, which requires that proper notice of a claim be given within 90 days of completion of your work. A lawsuit must be filed within one year of when work was performed or materials supplied. The deadlines for both bond and lien claims are mandatory and particular attention should be given to meeting all of the requirements in light of potential restrictions imposed by the automatic stay.

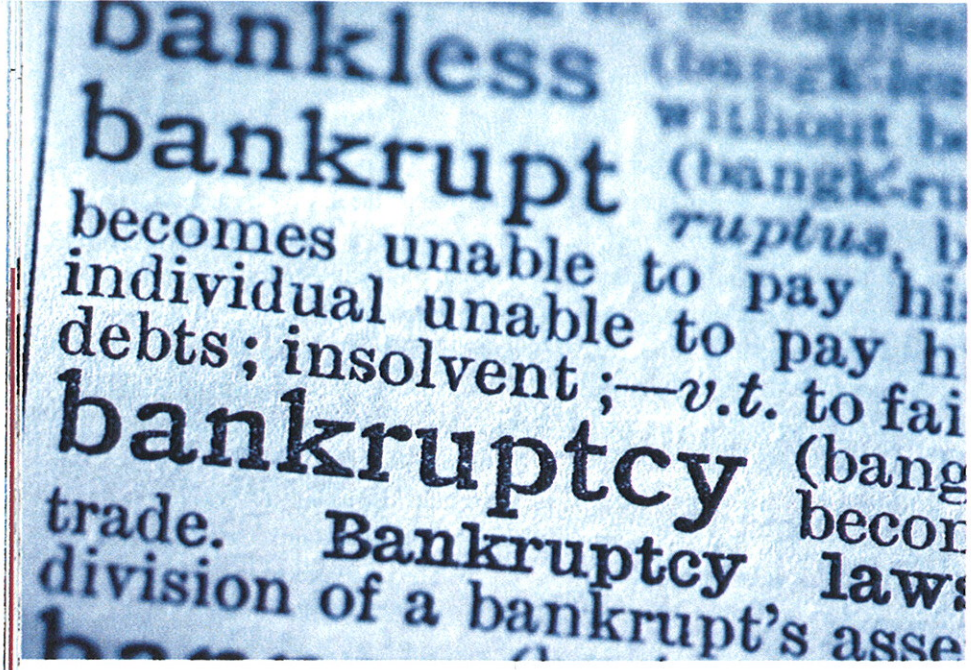

Larry Logsdon

What steps should you take in addition to a lien or bond claim?

Whether or not you have a lien or a bond claim, you should make sure you file an official notice of your claim (or "proof of claim") in the bankruptcy case. A "proof of claim" tells the bankruptcy court how much the debtor owes you on the day the bankruptcy case was filed. In every Chapter 11 case the court will establish a deadline to file the proofs of claim. Your form must be filed with the appropriate clerk of the bankruptcy court where the case was filed and, with limited exceptions, it must be filed before the deadline to be included for payment in any distribution. Filing the claim does not insure you will be paid in full, or at all; but failing to file in a timely fashion usually removes any chance of payment.

The debtor's plan in a Chapter 11 will propose how much it intends to repay its creditor. Many Chapter 7 cases do not have any assets to liquidate so there may not even be a claim deadline. If there are assets and a claim is filed, payments under a Chapter 7 case will depend upon the amount available to distribute and the size of your claim in relation to the other creditors in the case.

If more work is left to be performed under your contract, a contractor may want to file a motion in the bankruptcy court to request the trustee, or debtor in possession, to either "assume" or "reject" the contract. If your work is critical to complete the project, the trustee, or debtor in possession, may decide to assume, or continue with, your contract. To do so, it must cure all past defaults and agree to perform, in a timely manner, under the contract in the future. If your contract is rejected, a contractor is no longer obligated to perform the balance of work required and is entitled to file a claim for damages resulting from the rejected contract. This claim for rejection dam-



ages would be in addition to the proof of clam for unpaid work owing at the time of the bankruptcy filing.

What can a contractor do before a bankruptcy filing to reduce its risk of nonpayment by the general contractor?

If you are a subcontractor and have reason to question the financial stability of your general contractor, you may request to have the property owner make payment with a joint payee check. This will not help you get paid on past due progress payments, but if the general contractor files for bankruptcy, there is still the possibility prior payments you received could be recovered as a "preference." Amounts paid to you by the debtor within 90 days before bankruptcy are subject to forfeiture if the payments amounted to a "preference" by giving you more in comparison to other creditors. A joint payee check provides some defense against such a claim. Another safeguard is to simply use your judgment at the bid stage and weigh how important the risk is to your company. The profit may look great but if the project does not require a performance bond covering payment in the event of a default by the general contractor you need to consider whether your company could survive nonpayment by the general contractor or owner. It is also wise to confirm that a performance bond was actually purchased for the project rather than rely on the representations of those involved with the transaction. And, before starting work, obtain a copy of the bond so that you will have all information needed to file your claim if the need arises later in the project. Find a competent bankruptcy attorney now so that when, not if, the emergency arrives, you are well prepared.

When you first learn of a bankruptcy filing connected with a project you are working on as a contractor you should notify your attorney. If you do not have an attorney that is knowledgeable about bankruptcy it would be wise to shop around and find one you have confidence in before the need actually presents itself on the eve of a critical deadline. Even if you are not owed much on the project you may still need assistance with possible preference claims and filing a proof of claim. Bottom line, your attorney can help you identify and gather the information you need to minimize your loss and increase your recovery.

What is the conclusion?

The bankruptcy of one of your customers is never welcome news. Though it may not seem like it as you wind through the process, the Code includes provisions that protect both the debtor and creditor. As soon as you learn of the bankruptcy filing you should suspend further collection efforts and move swiftly to protect your payment rights provided by the Code and state law. Consult a bankruptcy attorney to seek his or her advice about lien and bond claims and to get assistance filing your proof of claim. In the end, your odds of receiving much from the bankruptcy case may still be low, but if you do nothing those odds plummet to zero every time. ■

After graduating from Harding University with a Bachelor of Business Administration degree in accounting, **Jay Clark** worked as an auditor with Ernst & Young in Birmingham and received his C.P.A. designation in 1989. After leaving Ernst & Young he attended Cumberland School of Law where he graduated magna cum laude in 1992. Clark regularly appears before the bankruptcy courts throughout Alabama in representation of secured and unsecured creditors in filing of claims, preference claim litigation, objections to confirmation, and pursuit of nondischargeability judgments.

Larry Logsdon joined Wallace, Jordan, Ratliff & Brandt in 1997. He practices in the area of general commercial litigation and represents general contractors, subcontractors, owners, and suppliers involved in all aspects of the construction industry. Mr. Logsdon is admitted to practice before the United States Court of Appeals for the 11th Circuit, all Alabama federal district courts, and all Alabama state courts.