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BANKRUPTCY

How to handle a stay during construction

Bankruptcies in the construction industry are ever-present in the continued economic downturn. The proper way to handle and respond to a bankruptcy in a given construction project will likely surprise you,

however. A bankruptcy filing has a ripple effect on the matrix of contracts in any construction project.

Here are some points to consider:

- **Hiring a replacement subcontractor** – Say, for example, you are a general contractor on an ongoing construction



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project. Your plumbing subcontractor files bankruptcy and stops operations. You immediately find and hire a replacement subcontractor, right? Wrong. Doing so might violate the law.

If your plumbing subcontract is executory, meaning there are outstanding performance obligations on both sides of the contract, then you cannot hire a replacement subcontractor without violating the bankruptcy stay.

The ramifications of this law can be enormous to a general contractor liable for liquidated damages for every day a project goes beyond the deadline.

To avoid violating the bankruptcy stay, you need to either seek approval of the bankruptcy court – Op-

tion 1 – or wait the requisite amount of time for the bankruptcy trustee or debtor to reject the contract – Option 2.

For Option 2, the amount of time required before a contract is considered terminated or rejected depends on whether the debtor files Chapter 7 or 11 bankruptcy. If you need an immediate determination, then Option 1 is the way to go.

The foregoing hypothetical applies with equal force to owners and general contractors that file bankruptcy. Ignorance is not a defense to violating a bankruptcy stay and courts take such violations seriously.

- **Mechanic's liens and materialmen's liens** – It is common knowledge that if an individual or business files a petition for bankruptcy, no creditor can file suit, make a claim or otherwise attempt to obtain satisfaction of an outstanding debt. So if you provided materials or labor on a construction project, you cannot file a mechanic's or materialmen's lien, right? Wrong again.

The bankruptcy code contains a specific exception allowing contractors and materialmen to file a mechanic's lien without violating the bankruptcy stay. In fact, the automatic bankruptcy stay does not prevent a contractor or materialmen from filing a lien. Instead, the same deadlines for filing a lien are in effect regardless of whether the owner or general contractor filed for bankruptcy. Therefore, you should not wait to file your mechanic's lien until the bankruptcy is discharged and the

pending bankruptcy does not toll the filing deadline.

Conversely, the bankruptcy stay prevents you from filing your suit to enforce a mechanic's lien. You must wait until the bankruptcy stay is lifted or the bankruptcy case is dismissed. When either event occurs, you must then file your suit to enforce mechanic's lien within 30 days of the date the bankruptcy case ends, within six months of the time the lien was recorded or 60 days from when the project was completed, whichever period is longer.

The automatic bankruptcy stay surprisingly does not prevent you from filing a mechanic's or materialmen's lien, but it does prohibit a suit to enforce your lien.

- **Retainage** – Regardless of whether you are an owner or contractor, contract retainage is likely part of the bankruptcy estate. In the case of the owner, it is money the owner owes to a creditor. In the case of a contractor, it is money owed to the contractor and, therefore, all creditors of the bankruptcy debtor may have an interest in the bankruptcy asset.

In either scenario, the retainage cannot be distributed or voided without the say-so of the bankruptcy trustee or relief from the bankruptcy court. If you need an immediate determination of how to handle retainage, you will likely need to file a motion for relief from stay to obtain court approval for your handling of the retainage.

If time is not an issue, you can likely await the trustee's determination of how to handle the retainage.

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