

Bankruptcy and the construction industry: What happens when the project owner files for bankruptcy?



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MH Business Exchange - Bankruptcy and the Construction Industry

It is clear that the construction industry has been impacted by the coronavirus pandemic. Project owners, contractors, material suppliers, and equipment lessors are understandably concerned as some construction projects have stopped work and others are stalling as developers evaluate the situation. In this volatile environment, those in the construction industry need to know how a bankruptcy might impact the projects where they are working. In this post, we will look at what happens when the project owner files for bankruptcy.

A bankruptcy begins once a debtor files a bankruptcy petition with the relevant federal bankruptcy court. Typically, within a week after the petition is filed, a “Notice of Commencement of Case” will be sent to all creditors listed as part of the bankruptcy petition. When the debtor is the project owner of an uncompleted construction project, the Notice of Commencement of Case will usually include the name(s) and contact information for the general contractor(s). If you are a creditor, you should file a “Request for Notice” with the bankruptcy court so that you receive future notices.

When a bankruptcy petition is filed, there is an “automatic stay” (or injunction) that prevents all entities from proceeding with any collection actions, legal proceedings, and judgment enforcement activities. The automatic stay only applies to collection actions, legal proceedings, and judgment enforcement activities

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directed at the debtor, and similar actions against non-bankrupt parties can proceed unless the bankruptcy court enters an order that provides otherwise. The situation gets complicated where a non-bankrupt party is proceeding against an entity that is not in bankruptcy but a debtor is directly affected by the collection actions, legal proceedings, and judgment enforcement activities, especially if the debtor is a party to legal proceedings where a non-bankrupt party wants to proceed.

The automatic stay does not prevent a non-bankrupt party from “recording” a mechanic’s lien where the relevant statute provides that the recording relates back to a period before the bankruptcy was filed. If a mechanic’s lien is going to be filed after the bankruptcy, there should also be a “Notice of Lien” filed in the bankruptcy that makes clear that the lien is being asserted but the automatic stay is not being violated. The automatic stay does, however, prevent a non-bankrupt party from filing or continuing a lawsuit to “foreclose” on a mechanic’s lien, and, if a lawsuit to foreclose on a mechanic’s lien has already been filed, a “Notice of Stay of Action” likely will be filed by the debtor in the state court proceeding.

A party to a construction project can also file a “Motion for Relief from the Automatic Stay” to permit the party to file or continue pursuing a lawsuit to foreclose on a mechanic’s lien. This is typically done if there is concern that the value of the property might decrease, the position of the mechanic’s lien holder may erode, or the owner lacks equity in the property.

After the filing of the bankruptcy, as a general contractor, you typically are required to continue to perform your work as set forth in any contract you have with the owner. Partially performed construction contracts are considered to be “executory contracts,” meaning the obligations of the parties to the contract have not yet been completely performed. The debtor, in Chapter 11 cases, gets to choose whether to assume or reject an executory contract. Also, provisions in a construction contract that “filing for bankruptcy is a material breach of the contract that allows the non-bankrupt party to terminate or stop performing under the contract” are generally unenforceable, with some narrow exceptions.

If the debtor decides to assume a construction contract, it must satisfy a few conditions and receive permission from the bankruptcy court. This can occur through a separate request by the debtor to the bankruptcy court or as part of a Chapter 11 plan process. If the debtor was in default prior to assuming the construction contract, the debtor is required to cure all monetary defaults and provide adequate assurance of future performance under the contract. The non-bankrupt party to the contract may object to the assumption of the executory contract if the relevant conditions are not met. The non-bankrupt party generally loses its right to later complain that the conditions were not satisfied once the time period to object has lapsed. If the contract is assumed, the debtor’s bankruptcy estate becomes bound by the contract, and all amounts owed thereafter by the debtor under the contract are usually entitled to be paid in full as administrative expenses.

If a trustee or debtor rejects a construction contract, the non-bankrupt party is no longer obligated to perform under the contract, and the debtor is liable for all damages caused by the rejection, which is considered a breach of contract. Damages caused by the rejection of an executory contract—such as lost profits and costs to retain a replacement contractor—are treated as unsecured claims that are typically paid a fraction of their face amount.

If you have not been paid for all of the work that you performed, you should file a Proof of Claim with the bankruptcy court unless the Notice of Commencement of Case indicates that no claims are to be filed. In Chapter 7 and 13 cases, the deadline to file a Proof of Claim typically is 90 days after the First Meeting of

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Creditors. In Chapter 11 cases, the local bankruptcy rules or the bankruptcy court sets the deadline to file a Proof of Claim. If you did not timely file a Proof of Claim you can ask the court for permission to file a late Proof of Claim but you have to satisfy the very difficult standard of “excusable neglect” for your failure to file a timely Proof of Claim to be considered excused.

These are complicated issues and missteps could have significant consequences. Please reach out to the McDonald Hopkins attorneys listed below with questions.



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