

Difficult Bankruptcy Decisions

What to Do When a Team Member Pulls Out of a Project

By Patrick Warfield and Matt DeVries

Construction projects require collaboration among many parties to ensure the work is completed. When one of those parties files for bankruptcy, finishing the project can be very difficult.

Imagine if a flooring subcontractor pulled all of its employees off the jobsite and declared bankruptcy a month before completing a project. The common-sense response by the general contractor would be to find another flooring subcontractor to complete the job. However, according to the bankruptcy code, the general contractor may not hire another subcontractor to complete the flooring without court approval. It may sound illogical, but that's what the law requires.

The Automatic Stay

Among bankruptcy topics, the "automatic stay" imposed by filing a bankruptcy petition is one of the most relevant issues to a contractor involved in a construction project.

The moment a business or person files for bankruptcy, the automatic stay of the bankruptcy code goes into place, defining what actions can and cannot be taken against the debtor. Classifying what the automatic stay prevents is somewhat hard to define; however, all those involved in a bankruptcy process should respect its prohibitions.

When the flooring subcontractor filed for bankruptcy, the automatic stay went into place and the subcontractor's/debtor's "bankruptcy estate" was created. The bankruptcy code defines the bankruptcy estate as essentially all "legal or equitable" property of the debtor at the time of filing. Examples of a debtor's legal or equitable property include tools left on the jobsite; unused materials owned by the debtor; any potential lawsuit the debtor could have asserted prior to filing bankruptcy and all executory contracts.

Clearly, the property the bankruptcy estate holds is expansive and broad. Absent court approval, the automatic stay prevents a general contractor from interfering with property of the debtor's bankruptcy estate. Additionally, the unfinished executory flooring contract becomes part of the estate at the time of filing.

Executory Contracts

Determining what qualifies as an executory contract can be difficult. In an executory contract, the obligations of both parties are so incomplete that a failure of either party to perform its obligation would be a material breach of the contract. With that legal definition in mind, it is clear that the contract between the general contractor and the flooring subcontractor is executory because failure to perform by either the general contractor or the subcontractor would be a material breach of the contract.

If a contract is deemed executory, then it becomes part of the bankruptcy estate and the debtor must decide whether to assume, reject or assign that contract. By forcing a debtor to decide what to do with the contract, the logic of the bankruptcy code begins to take form. The bankruptcy estate is created to maximize the value of the debtor's property in order to benefit its creditors. Because executory contracts lack full performance by both parties, they could provide value to the estate.

The flooring subcontractor's contract with the general contractor may not be profitable to the debtor because the contract price is less than the subcontractor's cost to install. Assuming this is true, the debtor would reject the contract because it provides no value to the estate. On the other hand, if the contract price pays more than the debtor's cost to install, the debtor probably would assume the contract and continue to perform. In other situations, the debtor may assign the contract to be performed by a third party that is willing to pay for the rights to perform on that contract.

Ultimately, the general contractor cannot obtain another subcontractor to finish the job because the executory nature of the contract creates value for the estate. Any effort of the general contractor to hire a new subcontractor would deprive the estate—and its creditors—of that value. If the contract is assumed, the debtor must cure all defaults and give the general contractor "adequate assurance" that it will perform the contract. If the debtor assigns the contract to a third party, it must first cure all defaults and then give adequate assurance that the third party will perform the contract. If the contract is rejected, it is deemed a breach of the contract and the debtor must pay damages equivalent to the amount as of the bankruptcy filing

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No creditor wants to sit around and wait for the debtor to decide whether to assume, assign or reject an executory contract. In many construction contracts, the general contractor may be required to pay liquidated damages for each day the project goes unfinished past the completion deadline. Given this, what should a general contractor do to speed up the debtor's decision regarding the executory contract?

First, if the subcontractor filed Chapter 7 bankruptcy (liquidation), the debtor must assume or assign the contract within 60 days or the contract is deemed rejected. On the other hand, if the subcontractor filed Chapter 11 bankruptcy (reorganization), the debtor has until confirmation of the Chapter 11 plan to make its decision, which could take more than a year.

Second, the general contractor could file a "Motion to Compel" the debtor to assume or reject the contract. This would be beneficial in a Chapter 11 case, or if the general contractor is approaching its completion deadline and may suffer liquidated damages due to the debtor's indecision regarding the executory contract.

Finally, if the general contractor wants to terminate the contract, it could file a "Motion for Relief from Stay," which would remove the contract from the bankruptcy estate and allow the general contractor to obtain another subcontractor to complete the project.

Although this scenario involves a subcontractor filing bankruptcy, the same rules apply if the owner or general contractor is the one filing. Prior to instigating any action against or affecting a bankrupt party, consult with an attorney to determine whether an action may violate the automatic stay. The penalties for violating the automatic stay can span from "voiding" the action to the court imposing actual or punitive damages against the violating party.

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