

Article

Prepare for the Worst and Get Paid by a Debtor in Bankruptcy

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Construction Executive

Construction projects frequently involve coordination among numerous parties operating with thin margins, so when one of the parties files for bankruptcy, the disruption can reverberate throughout the chain of payment. Rather than simply reacting to a bankruptcy filing after the fact, parties with an understanding of their rights and remedies can take steps now to help protect themselves later.

AN OUNCE OF PREVENTION

Parties involved in a construction project generally have the same goals: finish the project in a timely and efficient manner and receive payments for their efforts. Therefore, parties should strive to resolve payment disputes outside of the courtroom, where they are not restricted by rigid requirements and are free to craft creative solutions that can advance their common goals. Deferring payments or renegotiating contract terms in exchange for additional protections or other considerations can serve as a cost effective remedy to prevent a project from completely derailing. Timely dialogue is key.

MECHANICS' LIENS

When faced with potential non payment, construction companies can often protect themselves by filing a traditional mechanics' lien against the real property, which encumbers the interests of the property owner, even if the construction party has no privity of contract with the owner. Every state has laws that allow a party to secure payment for goods supplied or labor furnished to improve real property by granting it a lien against the property. Requirements as to when the lien must be filed, how notice must be provided, and when the lien may be enforced or foreclosed upon vary from state to state. Failure to precisely adhere to the requirements could result in a waiver of a party's lien rights.

BANKRUPTCY

A mechanics' lien is especially valuable when a general contractor or paying subcontractor files for bankruptcy protection, because the bankruptcy laws generally protect only the debtor, and lien rights against a non debtor property owner may still be enforced. Having a valid and enforceable mechanics' lien on collateral that secures repayment provides a source of recovery not shared by general unsecured creditors. In particular, a construction party with a properly perfected mechanics' lien (or contractual security interest) is a secured creditor, whose claim will be paid before any unsecured creditors—including any construction parties who failed to timely perfect their own mechanics' liens.

Where the creditor cannot resort to collateral, it can still take steps to protect itself in advance by seeking and preserving rights against non debtor parties.

For example, a fundamental protection afforded to a debtor in bankruptcy is the "automatic stay," which immediately bars creditors from taking any action, with certain exceptions, to collect debts from the debtor. A party who violates the automatic stay could be subject to liability for the debtor's attorneys' fees and other sanctions by the court. The automatic stay generally only applies, however, to actions against the debtor and its property, as opposed to third parties.

Therefore, in addition to grants of collateral (including mechanics' liens and offset rights), holding rights that do not run against the bankrupt debtor, such as guaranty rights or letters of credit extended by third party lenders at the behest of the debtor, can be an effective way to maximize recoveries. Principal guaranties can also often effectively discourage bankruptcy filings where the principal knows that the result of the debtor's bankruptcy will be enforcement actions against it, as guarantor.

CONCLUSION

In construction, the most cost effective solution is often the DIY solution, and collecting on an unpaid construction debt is no different. Working out a payment dispute between the parties allows the parties to quickly get back to the project at hand while avoiding many of the pitfalls associated with legal proceedings. In advance and apart from such workout efforts, construction creditors should know their statutory rights to assert tools for recovery and should attempt to maximize payment rights against additional parties to protect themselves in the event that one such party files for bankruptcy. A complete discussion of bankruptcy issues is beyond the scope of this article, and therefore, prudent parties faced with bankrupt debtors should seek the guidance of legal counsel in navigating the process.

An Nguyen focuses his practice on representing Chapter 11 debtors, trustees, committees and secured and unsecured creditors in bankruptcy and related litigation. His clients include companies and business owners in various industries, such as oil and gas, retail and entertainment. He is in Munsch Hardt's Austin office.

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Primary Contacts



Thanhhan Nguyen

Austin
512.391.6142
anguyen@munsch.com

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