Six Contracting Tips for Property Owners and Real Estate Developers to Protect Themselves from Contractor Distress and Related Bankruptcy Filings

Over the past year, the Covid-19 pandemic upended many industries. While the construction industry has largely been able to operate throughout the pandemic, albeit with increased and ever-changing restrictions on jobsites, one consequence of these disruptions may be an increase in construction-related bankruptcy filings. Already in 2021, there have been over 70 construction-related bankruptcy filings across the country. For many property owners and real estate developers, these filings create a nightmare scenario where work may slow or even stop entirely.

The time is ripe, therefore, for a quick reminder for how property owners and real estate developers can protect themselves – and their projects – from downstream distress. Below are six key issues that owners should consider when contracting for their next project – or amending agreements on current projects – and how they may impact an owner’s rights in a contractor’s or subcontractor’s bankruptcy.

Identify “Red Flags” Regarding a Contractor’s Financial Condition

Consider the “red flags” that precipitate, or may indicate, contractor distress and identify them either as events of default or notice events. For example, a contractor’s termination of a key employee, failure to maintain an adequate workforce, or delayed deliveries of materials to a project site all may indicate financial distress. Similarly, a contractor’s termination of a subcontractor also may indicate problems with a project. An owner that can identify these events early, as either events of default or notice events (with consultation rights), is well positioned to avoid unwanted surprises. To facilitate this oversight, owners may consider including provisions in their contracts that allow for routine review of schedules, milestones, and other important submittals during the course of a job. An owner should also be on the lookout for mechanics liens filed against the project or the property by a subcontractor or supplier, which indicate contractor default or inability to complete the contract.
Allow for the Expedited Termination of Contracts

A bankruptcy filing by a contractor can create uncertainty and delays on a job site because owners are restricted in what actions they can take against the contractor, while the contractor can continue to enforce its contract with the owner. This is true even if the contract provides that it will terminate upon a contractor’s bankruptcy filing as such provisions are not enforceable in bankruptcy. Consequently, the surest way to avoid exposure to the risks and delays of a bankruptcy is to terminate, and replace, a distressed contractor before they file for bankruptcy. This is obviously easier said than done – though that’s why the “red flags” are useful. By ensuring that an agreement allows for an expeditious termination process, an owner can increase the odds that an agreement is no longer effective (or curable) by the time a contractor files for bankruptcy. For example, owners may consider including provisions that allow for termination for convenience, a shortened cure period following notice of a default, or for immediately effective notice of default by email. If the owner isn’t able to terminate the contract before bankruptcy, it must tread cautiously to ensure compliance with the bankruptcy rules and procedures – the most relevant of which are addressed below.

Address the Automatic Stay

Immediately upon filing for bankruptcy, a debtor is protected by the “automatic stay.” This prohibits most collection and enforcement actions against a debtor, unless authorized by the bankruptcy court. An owner, therefore, must request relief from the automatic stay if it wishes to terminate an agreement with a contractor-debtor. Relief, however, is not immediate nor guaranteed, and can be expensive. In anticipation of this issue, owners may wish to require that a contractor agree that, in the event the contractor files for bankruptcy, it will not oppose a request by the owner for relief from the automatic stay. The enforceability of such a waiver, however, is not guaranteed, and an owner will still need to satisfy its burden under the Bankruptcy Code to demonstrate “cause” to lift the stay.

Set a Deadline for the Debtor to Assume or Reject the Construction Contract

A construction contract is likely to be considered an “executory contract.” This means that a contractor-debtor can either assume or reject the agreement, and will typically have until confirmation of a plan of reorganization to decide (which could be 6+ months after the filing date). This is true even if the agreement provides that it will automatically terminate upon a bankruptcy filing because, as noted, such provisions are not enforceable under the Bankruptcy Code. Owners, however, may want a contractor-debtor to assume (and cure existing defaults) or reject (and allow the owner to replace the contractor) an agreement prior to confirmation to allow for greater certainty regarding the performance of a project. To expedite the assumption/rejection process, an owner may wish to negotiate for the inclusion of a requirement in its contracts that, in the event the contractor files for bankruptcy, the contractor agrees to assume or reject the agreement within a specified period, e.g. 30 or 45 days after filing bankruptcy. The enforceability of such a provision is not guaranteed; however, it may strengthen an owner’s argument that the debtor should be compelled to immediately assume or reject its agreement. Similarly, the inclusion of certain representations regarding the timing of a project, and an acknowledgment of the damage to the project if the contractor fails to satisfy its obligations, may also be helpful to an owner’s request.

State How Damages under a Contract are to be Calculated

Calculating damages and identifying all defaults under a construction contract can be difficult (and expensive), yet a debtor cannot assume an agreement without first curing the existing defaults. To
help avoid costly disputes over identifying and calculating damages, agreements should include clearly drafted liquidated damages provisions. Additionally, owners should negotiate for the right to review a contractor’s books and records or other “audit rights” in connection with a payment application or as a remedy for an event of default, and be sure the agreement does not contain a waiver of consequential damages (unless there is a liquidated damages provision). These rights may help an owner who needs to prove damages.

**Bonds and Joint Checks**

Owners should be concerned subcontractors or others will look to them for payment that distressed contractors failed to make. To avoid this situation, owners should require contractors be “bonded” or provide for the use of joint checks at the owner’s discretion.

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