



Bankruptcy pitfalls in construction projects and the issues an owner will face

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When a developer or owner goes bankrupt, the effect on a construction project's completion is clear.

What is less clear is the effect on the project's completion when the general contractor files for bankruptcy protection. The constraints of this article preclude addressing every possible scenario or contingency; however, it can give a general overview of the two most pressing issues that an owner will likely face.

The first issue an owner must deal with is ensuring the project can continue without the contractor. Pursuant to Bankruptcy Code Â§362, any action against the debtor or the debtor's property is subject to an automatic stay. This is important because if the owner did not terminate the contract prior to the bankruptcy filing, the contractor's rights under the construction contract are included as assets of its bankruptcy estate, and are subject to the stay. Unless the contractor rejects the contract (exposing itself to damages for breach of contract), the owner must apply to the bankruptcy court for relief¹ in order to lift the automatic stay (at least as to the owner) before being able to proceed with a replacement contractor.

However, if a contract was properly terminated prior to the bankruptcy petition date, the automatic stay would not affect the owner's ability to immediately hire another contractor to complete the work.

Although a contractual provision providing for termination upon the contractor's insolvency and/or filing a bankruptcy petition would seem to be the easy solution, these "ipso facto clauses" are prohibited under current bankruptcy laws.² Termination is permitted, however, pursuant to any termination clause not triggered to the financial condition of the contractor, including an unconditional right to terminate.³

The second main issue that will likely face an owner when its general contractor files for bankruptcy is its potential exposure to mechanic's liens filed by subcontractors of the bankrupt contractor. Under current New York law, it is unclear if an owner will be exposed to lien foreclosure actions of subcontractors during the bankruptcy process. While one federal bankruptcy court sitting in New York has held the stay applies to a subcontractor foreclosure action, at least one New York State Court disagrees. The two conflicting cases are discussed below.

In *Matter of Omni Facility Services, Inc.*,⁴ the Bankruptcy Court, S.D.N.Y. determined that a subcontractor's foreclosure action against the property owner was an "attempt to recover a claim against a debtor" (in this case, a Chapter 7 petitioner) and was therefore subject to the automatic stay.⁵ The Court reasoned that since Â§ 362(a)(1) stays actions (i) against the Debtor or (ii) to recover a claim against the debtor, the provision must include "cases in which the Debtor is not a defendant; it would otherwise be totally duplicative of the former category and pure surplusage."

In contrast, a New York State Court has held that the automatic stay does not apply to a subcontractor's lien foreclosure action. In *Strober Brothers, Inc. v. Kitano Arms Corp.*, Kitano Arms

Corp.⁶ (Kitano) hired Francis A. Lee, Inc. (Lee) as its general contractor in connection with the renovation of the Kitano Hotel. Lee subsequently hired Strober Brothers, Inc. (Strober) as a subcontractor for the project. Strober initiated a foreclosure action in May, 1994, claiming approximately \$66,000 due it from Lee for materials supplied to the project, bringing into the action other subcontractors who had also filed liens.

In September, 2004, Lee filed for Chapter 11 bankruptcy protection in the Eastern District of New York. Kitano subsequently made a motion to stay Strober's foreclosure action, based on Lee's bankruptcy filing. In affirming the trial court's denial of Kitano's motion (although for different reasons), the First Department held "neither the Bankruptcy Code nor the CPLR compels a stay of the lien foreclosure actions against Kitano at this time,"⁷ finding "Kitano is not itself a bankruptcy petitioner and has legal interests quite distinct from those of Lee."⁸ The First Department's decision did not specifically address the Omni Court's reasoning that a subcontractor's lien action was 'an attempt to recover a claim against the debtor' and that the stay is therefore applicable.

Based on Strober above, it appears an owner may have to address subcontractor lien claims immediately, regardless of the automatic stay of all claims against a debtor contractor. However, an owner can, by including the necessary protection in its contract, ensure the contractor's bankruptcy has a minimal effect on the timely completion of the project.

It is strongly suggested that a prudent owner in these troubled financial times consult a construction law specialist to review and adopt the construction manager's or general contractor's contract to afford ultimate protection to the owner.

Footnotes:

1. Pursuant to 11 U.S.C. Â§ 362(d)
2. See 11 U.S.C. Â§Â§ 541(c)(1) and 365(e)(1)
3. See *Greene Technologies Inc. v. Atoma International of America, Inc.*, 296 A.D.2d 695, 745 N.Y.S.2d 242 (3rd Dep't 2002).
4. Case No. 04-13972 (Bankr. S.D.N.Y.)
5. Citing *In re Colonial Realty Co.*, 980 F.2d 125, 61 USLW 2334 (2d Cir. 1992)
6. 224 A.D.2d 351, 638 N.Y.S.2d 90 (1st Dep't 1996)
7. *Kitano*, 224 A.D.2d at 353.
8. *Id.*

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