



# LEGAL NOTES



ABA – ARIZONA BUILDERS' ALLIANCE  
An Association of ABC Arizona and AGC Arizona Building Chapter  
1825 W. Adams, Phoenix, AZ 85007 (602) 274-8222 FAX: (602) 274-8999  
1661 N. Swan, Suite 144; Tucson, AZ; 85712 (520) 881-7930; FAX: (520) 327-1686

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## CONSTRUCTION & BANKRUPTCY

**Matthew H. Sloan, Esq., Corey R. Foley, Esq. and Kristin W. Mazon, Esq.  
Jennings, Haug & Cunningham, LLP**

These are tough times for the construction industry. The current economy has resulted in fewer projects being started, and many current projects being stalled due to a lack of funding. Now more than ever, projects are being faced with the bankruptcy of an owner, general contractor or subcontractor. This article identifies and discusses some of the issues that may be encountered by construction professionals, including claims arising under Arizona's Prompt Pay Act and situations where a bankruptcy is filed.

### **I. AN OWNER'S FAILURE TO OBJECT IN WRITING TO A CONTRACTOR'S PAYMENT APPLICATION GIVES RISE TO A "PROMPT PAY" CLAIM UNDER ARIZONA LAW**

Construction contracts between owners and contractors typically provide for progress payments as a result of monthly payment applications in compliance with contract requirements. Unless a construction contract clearly provides for a longer payment time, owners are required to pay progress payments within seven days after a payment application is approved. A contractor's payment application is deemed approved and certified 14 days after it is provided to an owner if no written objection is made. An owner's failure to issue a detailed written objection within 14 days, and subsequent failure to timely pay, gives rise to the unpaid contractor's Prompt Pay claim under Arizona law.

A contractor's Prompt Pay claim includes the unpaid balance, as well as mandatory interest at a rate not less than one and one-half per cent a month (18% per year)

on the unpaid balance. In addition, in any action brought to collect payments or interest, a successful party is entitled to an award of costs and reasonable attorney fees. It is important to note that, however, the "approval or certification" of the application of payment is not regarded as conclusive that the work was performed properly.

The purpose of Arizona's Prompt Pay Act is to require owners to identify and disapprove any items that need to be corrected early in the process so the contractors, subcontractors, and material suppliers receive prompt payment for their work or materials. An owner may not withhold payment on an invoice for alleged problems with other work not covered by the payment application. The Prompt Pay Act also obligates contractors who receive payment from owners to pay applications of its subcontractors and suppliers within seven days for the full amount received for a subcontractor's work or materials supplied. There is not a similar obligation on contractors to object in writing to payment applications of subcontractors or material suppliers under the Act.

### **II. WHAT IF MY SUBCONTRACTOR FILES BANKRUPTCY?**

#### **What Does it Mean When a Contractor or Owner Files Bankruptcy?**

Filing bankruptcy means that a bankruptcy petition has been filed with the Bankruptcy Court. The contractor or owner becomes the "debtor" and an "estate" is created. The bankruptcy estate consists of all

#### **ABA LEGAL NOTES**

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the property and property interests of the debtor—basically every conceivable interest of the debtor in the property.

Simultaneous to the filing of a bankruptcy petition, the bankruptcy code imposes an automatic stay. The automatic stay is applicable to all entities, against all collection activities or other acts that would improve a creditor's position against the debtor or the debtor's property. The automatic stay effectively halts all activity regarding the debtor's estate. The automatic stay is not something to be taken lightly. Essentially once the automatic stay is in place permission must be sought from the Bankruptcy Court before anything can be done.

When a contractor or owner files bankruptcy, the first determination that should be made is whether you are a secured creditor or an unsecured creditor. This matters because secured creditors get paid before unsecured creditors. In Arizona, the filing of a mechanic's lien secures your interest in the debtor's property, classifying you as a secured creditor.

### **Do I Have To Pay The Subcontractor?**

It is unsettling to any contractor to learn that the subcontractor with whom it is dealing on a project or projects has filed a bankruptcy petition.

When the subcontractor is presently performing without default, the bankruptcy filing itself gives no grounds for termination of the contractual relationship or withholding of funds. This is true even if your subcontract says bankruptcy is an event of default. Nonetheless, any contractor dealing with a debtor/subcontractor will be reluctant to pay out funds owed because of fears that the debtor/subcontractor will not be able to perform and finance the contract work to completion. For example, it may be readily apparent that the balance of subcontract funds remaining will not be enough to cover the cost of completing the subcontract work and paying the bills to labor and material suppliers.

Insisting on compliance with contractual requirements of joint checks or conditional lien waivers as a precondition to payment may be helpful. Construction contract provisions often make delivery of lien waivers from subcontractors and material suppliers a precondition to the right to progress payments. The contract may provide that progress payments can be made by check jointly payable to the subcontractor and its subcontractors or material suppliers. A debtor/subcontractor who is not paying project bills will not be able to satisfy the lien waiver precondition, thereby excusing the contractor's duty of payment. Joint checks ensure that the sub-subcontractors and material

suppliers will be paid. In some cases, contract provisions may permit the contractor to pay second tier subcontractors and suppliers directly, thereby offering additional protection from the subcontractor's bankruptcy.

### **Can't I Just Terminate The Subcontract?**

The subcontractor's bankruptcy filing results in an "automatic stay" of any collection or enforcement actions against the subcontractor. When the debtor/subcontractor is in default under the terms of the construction agreement, but the contract requires certain formal notices (a condition found in American Institute of Architects (AIA) form documents and commonly found in most preprinted form construction contracts), the party under contract with the debtor must file a motion with the Bankruptcy Court for relief from the automatic stay before giving contractually required termination notices. Stay relief is required, no matter how hopeless the debtor's condition may be and no matter how improbable the debtor's ability to assume and complete the subcontract may be.

### **Can I Just Ignore The Bankruptcy?**

Stay relief must be obtained before terminating the subcontractor or taking over the subcontractor's work, even if the subcontractor concedes the default or abandons the project. A decision of the Colorado Bankruptcy Court held that even if the parties agree not to rely upon or invoke the provisions of the automatic stay, the Bankruptcy Code's requirements must be met. Actions undertaken by a contractor with respect to the construction subcontract without relief from the stay are "invalid, void and of no force and effect."

Accordingly, the obliging subcontractor who abandons the job the day after the bankruptcy petition and expresses no objection to someone else completing the subcontract work should be required to stipulate to the appropriate stay relief, and that stipulation should be presented to the court at the earliest opportunity. Otherwise, the contractor bears the risk that someday a creditors' committee or a later appointed bankruptcy trustee may reconsider that decision and possibly challenge the subcontract termination or make claim to subcontract proceeds that were earned but unpaid at the time the bankruptcy was filed. The subcontractor's agreement or acquiescence, not formalized in compliance with the Bankruptcy code requirements, will be of no use in defending the actions of the contractor who informally treated the contract as terminated.

### **III. WHAT IF MY GENERAL CONTRACTOR OR OWNER FILES BANKRUPTCY?**

#### **Can I Stop Working?**

Interestingly, this is a fairly tricky question. Generally, the non-debtor party to a contract is held not to have the right to refuse to render performance to the debtor. The concept behind such a rule is that the non-debtor party to an “executory contract<sup>1</sup>” will be protected by “administrative expense priority” for any post bankruptcy performance, and the debtor’s prospects of reorganization would be destroyed if every counterparty to a contract could immediately suspend performance. The debtor is granted a measure of “breathing space” in which to decide whether to assume or reject each of its executory contracts.

However, Arizona’s enactment of prompt pay statutes, which in some instances expressly grant the right of suspension of performance to a contractor, will clearly conflict with the above stated general principle of law. Will this be a case where federal law governs? Or, does every construction contract in Arizona include this right to suspend work, thereby leaving the bankrupt owner/contractor with no greater rights than it would have had outside of bankruptcy? There is yet no answer to this question.

#### **The Owner Paid The General Contractor/Debtor For My Work The Day Before He Filed Bankruptcy. Do I Get My Money?**

Maybe. But only if you ask for it. Funds that the Debtor holds in trust for others may not be spent by the Debtor for other purposes. Many states have fairly far-reaching trust fund statutes, restricting a contractor’s ability to use job proceeds for any purpose other than the payment of the project bills. In Arizona, there is no such overriding construction trust fund statute, only a residential construction trust fund statute.

However, the construction contract between the Owner and the Debtor may impose a trust upon all contract payments for the benefit of unpaid subcontractors and suppliers. In some instances, bankruptcy courts have been known to uphold such contractual trusts, and order the money paid to the intended beneficiaries. However, such arguments must be made to the Bankruptcy Court promptly (before the money is gone) and properly, as a motion for relief from stay, or motion to segregate cash collateral.

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<sup>1</sup> Generally speaking, a contract under which some performance is still outstanding from each party.

#### **Can I Go Pick Up The Materials That I Delivered Just Before The Filing Of The Bankruptcy?**

Under Arizona law, a seller of goods has the right to stop the delivery of the goods when he discovers that the buyer is insolvent. Further, where the goods have been sold on credit while the buyer is insolvent the seller is entitled to reclaim the goods within 10 days after they have been delivered. The recent Bankruptcy law amendments have expanded the rights of a creditor to recover goods. The Bankruptcy Code now provides that a creditor who has provided goods on credit while a debtor was insolvent may make a written reclamation demand (demand for return of the goods) no later than 45 days after receipt of the goods or, if the debtor files a Bankruptcy petition during that 45 day period, no later than 20 days after the petition date. As an example, suppose that on March 1, 2009 a supplier, “Plumb-R,” sells plumbing equipment, to a contractor “Build-R,” on credit for \$20,000. On March 15, 2009, Plumb-R discovers that Build-R is insolvent. Plumb-R doesn’t have the right to demand return of the goods under Arizona state law, unless Build-R misrepresented its solvency at the time of sale, because more than ten days have passed since the plumbing equipment was delivered. However, on April 1, 2009, Build-R files for Bankruptcy protection. Plumb-R would then have 20 days in which to file a written notice of reclamation. If the air conditioning equipment cannot be redelivered to Plumb-R, then Plumb-R may receive an administrative priority claim in the bankruptcy case for the value of the equipment. The administrative claim would place Plumb-R in front of most unsecured creditors for repayment.

Even if a vendor fails to timely file a reclamation notice, the new Bankruptcy laws contain an additional modification that may substantially benefit the seller of goods. As modified, the law now provides that a seller of goods will receive an administrative claim to the extent of the value of the goods received by the debtor within 20 days before the bankruptcy petition so long as the goods were sold to the debtor in the ordinary course of the debtor’s business. In short, the new Bankruptcy laws appear to contain reclamation rights that might be considered more favorable to creditors than those that exist under State law.

#### **Can I Still File A Mechanic’s Lien Against The Contractor/Owner?**

The short answer in Arizona is yes. Whether it be the general contractor or the owner who files bankruptcy, the right of a claimant to record a mechanics’ lien after the bankruptcy filing is heavily dependent upon the provisions of the particular state’s mechanics’ lien laws.

Where those statutes permit the lien to relate back to the commencement of construction or to some other prior date, then the automatic stay does not prohibit recording or perfection. (Arizona is such a “relation-back” state). Conversely, where the state law does not provide for relation back, it is equally clear that the recording of a mechanics’ lien post petition will violate the automatic stay. In states that have statutes permitting “stop-notice” rights to relate back, or providing other construction industry remedies that would have retroactive priority, these rights can also be perfected after bankruptcy by procedures of notice or recording.

### **What Should I Do If My Six Months To File A Foreclosure Suit Arrives?**

When the automatic stay is applicable to prohibit the commencement of a lien foreclosure action, the Bankruptcy Code provides an alternative method of accomplishing this final act of “perfection.” You can file a Notice of Lien Preservation and Perfection with the Bankruptcy Court. In Arizona, the foreclosure suit is viewed as the final act necessary to perfect your lien rights and filing a Notice of Lien Preservation and Perfection would accomplish that required perfection.

### **Does The Bankruptcy Affect When I Have To Foreclose My Mechanic’s Lien?**

Once the Notice of Lien is recorded and the Notice of Lien Preservation and Perfection is filed with the Bankruptcy Court in lieu of commencement of a foreclosure suit, what happens to the lien? You must commence a lawsuit to foreclose on your mechanic’s lien within 30 days after the automatic stay is lifted by the Bankruptcy Court. This means that you need to wait until the Bankruptcy Court terminates the owner or contractor’s bankruptcy and lifts the automatic stay. Once the automatic stay is lifted, you can enforce your lien rights.

Alternatively, if you want to try and avoid waiting until the Bankruptcy Court terminates the bankruptcy and lifts the automatic stay, you can have an attorney file a motion seeking relief from the automatic stay. This should be done at your earliest opportunity, particularly when the mechanics lien is against a non-debtor’s property.

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