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A Construction Contract In Bankruptcy

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The views and opinions expressed are mine and do not necessarily represent official policy, position, or views of the North Carolina Department of Justice.

Nothing in this presentation constitutes the provision of legal advice or services, and no attorney-client relationship is formed.

Key Topics

- Documentation is important.
- Respect the automatic stay.
- Know what needs to be done and the cost.
- Be flexible.



At the start of a project, everyone is excited and shares a common goal: deliver the project on time and on budget.



But something goes wrong!

Disagreements ensue. The parties butt heads, frustrations grow, and the project becomes a dumpster fire!



And a contractor or a subcontractor runs out of money!





**The “B”
word!**

Bankruptcy

- Chapter 7
- Chapter 9
- Chapter 11
- Chapter 12
- Chapter 13





Chapter 7 – Liquidation

- Referred to as “complete bankruptcy,” “straight bankruptcy,” or “liquidation.”
- The entity that files this ceases to exist, stops business operations.

Chapter 11 – Restructuring

- Mainly applicable to companies that prefer continuing with their business operations through reimbursing creditors by acting upon a court-permitted restructuring plan.
- Some debts are paid, others wiped clean.



What are the owner's options?
Can the project be completed?
Should the owner terminate?

No options are a “clean break”.

Each require time, effort, and planning.

Can an owner terminate a contractor because of a bankruptcy filing?

NO!

...it is well-established that *ipso facto* clauses are unenforceable as a matter of law under the Bankruptcy Code. ... This is because the whole purpose of filing for bankruptcy is to provide the debtor with a "fresh start," and enforcement of *ipso facto* clauses would punish debtors by negating this central purpose.

In re W.R. Grace & Co., 475 B.R. 34, 152 (D. Del. 2012)(internal citations omitted)

First – Do Nothing!

An **automatic stay** took effect with the filing of the bankruptcy.

Do not do anything to end or negatively effect the contract.

The contract is an asset of the bankruptcy estate.

- An automatic stay applies upon the contractor's filing of its bankruptcy petition. The stay **precludes** the project owner from terminating the contract with the contractor.
- The owner cannot take any steps that may affect the contractor's interest in the project.
- The automatic stay will prevent the owner from initiating or continuing a claim against the general contractor's performance bond, its surety.
- The stay prevents the owner from disbursing funds under the contract with the debtor.
- The stay prevents the owner from completing the work under the debtor's contract.
- Must seek court approval to take action under the contract.



Ramifications of violating the automatic stay?

- Any action taken in violation of the stay is void as a matter of law.
- Violation of the automatic stay by a party who is aware of the bankruptcy filing can be extremely costly, potentially subjecting the party to assessment of attorneys' fees and other compensatory damages sustained by the debtor as well as punitive damages. CONNER GWYN SCHENCK PLLC, NORTH CAROLINA CONSTRUCTION LAW § 12:5 (2022)
- Other creditors may be entitled to damages as well, especially due to the confiscation of property on which they have an interest.

Can a subcontractor stop working or delay?

Can a supplier cancel an order?

NO!

- A subcontractor to the GC or a lower tier contractor cannot stop or slow down its performance.
- A supplier cannot refuse to supply materials.
- The GC can assume or reject contracts.
- Until a contract is rejected, the GC still has contract rights that it can enforce against others under the respective contracts and agreements. The same goes for subs and their contractors and suppliers.
- The subcontractor should provide a claim/notice to the payment bond company showing what has been paid, what invoices were submitted but not paid, and the balance to finish.

Second – Get help.

The deadlines and impacts of the bankruptcy depends on

- The type of bankruptcy,
- Who filed for bankruptcy (known as the debtor), and
- The status of the project.

You should contact legal counsel for assistance.

How does bankruptcy by a contractor impact a project?

Chapter 7

In most cases, a contractor will liquidate the company and will not continue performance under its construction contract. The contract is over.

In some circumstances, the trustee may complete the construction contract when it is determined by the bankruptcy court that it is in the best interests of the creditors to do so. The contract continues.

Chapter 11

A contractor may continue to operate during the bankruptcy. It and/or the Trustee may choose to complete current construction contracts, with oversight from the bankruptcy court and subject to the rights of its creditors, including the other parties on the construction projects.



Executory Construction Contract

Chapter 7

The Contractor/Trustee must assume the contract within **60 days** after the bankruptcy filing. If not, the contract is rejected. 11 U.S.C.A. § 365(d)(1)

Chapter 11

The Contractor/Trustee may assume or reject the construction contract any time before confirmation of a plan of reorganization. 11 U.S.C.A. § 365(d)(2)

The owner can file an application to require the Contractor/Trustee to either assume or reject the contract within a deadline.

Owner will need to support its asserted deadline, why that deadline is reasonable.

The work is in a state of uncertainty until the decision is made to assume or reject the construction contract.

What if the contract is rejected?

Then the contractor is in breach and the owner may proceed with Articles 28, 29, or 54.

NC SCO General Conditions (OC-15) 24th Edition, January 2013

- Article 54 – Termination for Convenience
- Article 29 – Termination for Default (Annulment of Contract)
- Article 28 – Owner’s Right to do Work



Completing the Work under Rejection.

- Demand on Surety
 - Surety would have a claim against the debtor in bankruptcy
 - Surety would want to protect the contract balance
- Self-Performance/Replacement Contractor
 - The owner may use the remaining unpaid balance of the contract to pay for completion.
- BUT:
 - The Court may require an accounting of the completion.
 - Any surplus funds must be paid to the bankruptcy estate.
 - Any excess expense, would be an unsecured non-priority claim.
- Must comply with Articles 28 and 29.



How about amounts owed under a contract?

- Amounts owed to the owner can be deducted from retainage and amounts owed to the contractor, but the owner will not be able to recoup beyond the funds it currently holds.
- I.E.:
 - Costs to complete work or the project
 - Costs to fix deficient work
 - Costs resulting from violations of law/regulations
 - Liquidated Damages
 - Other alleged damages
- Unless secured, an amount owed pursuant to a contract is an unsecured non-priority claim.
- **Be sure to file a Proof of Claim, with support, within the deadline!**

How do you know what work has been done and its cost?

Every project must have a **schedule of values**! (Art. 31)

The SOV is how the designer or architect of the project determines the progress and completion of the work in conformity with the Contract.



Order of Claims

- **Secured claims** are paid from the proceeds of the collateral; if the collateral is insufficient to pay the claim in full, the balance becomes an unsecured claim.
- **Unsecured Claims** are paid according to their priority as listed in 11 U.S.C. § 507. Claims in the higher priority are paid in full before claims in a lower priority receive anything.
- Within a class of claims, unsecured creditors share the available funds in proportion to the size of their claim.



Priority of Claims @ 11 U.S.C. § 507

1. Claims for debts to spouse or children for court ordered support
2. Administrative expenses of the bankruptcy
3. Unsecured, post petition claims in an involuntary case
4. Wage claims of employees and independent salespersons up to \$10,000 per claim
5. Contributions to employee benefit plans up to \$10,000 per employee
6. Claims of farmers and fishermen against debtors operating storage or processing facilities.
7. Layaway claims of individuals who didn't get the item they made the deposit on
8. Recent income, sales, employment or gross receipts taxes



Mechanics' Liens

- A bankruptcy petition filed by a general contractor will not affect the rights of its subcontractors and material suppliers to assert their rights under the North Carolina mechanics' lien law against the real property which is the subject of the improvements, or against any funds owing from the owner to the general contractor. CONNER GWYN SCHENCK PLLC, NORTH CAROLINA CONSTRUCTION LAW § 12:3 (2022)
- See N.C. Gen. Stat. Ann. Ch. 44A, Article 2
- This does NOT apply to public bodies or buildings.
- N.C. Gen. Stat. § 44A-34 expressly excludes public bodies and public buildings from the operation of North Carolina's mechanics lien laws in Article 2 of Chapter 44A

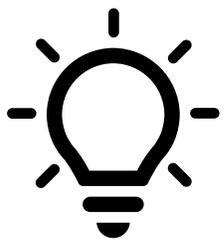
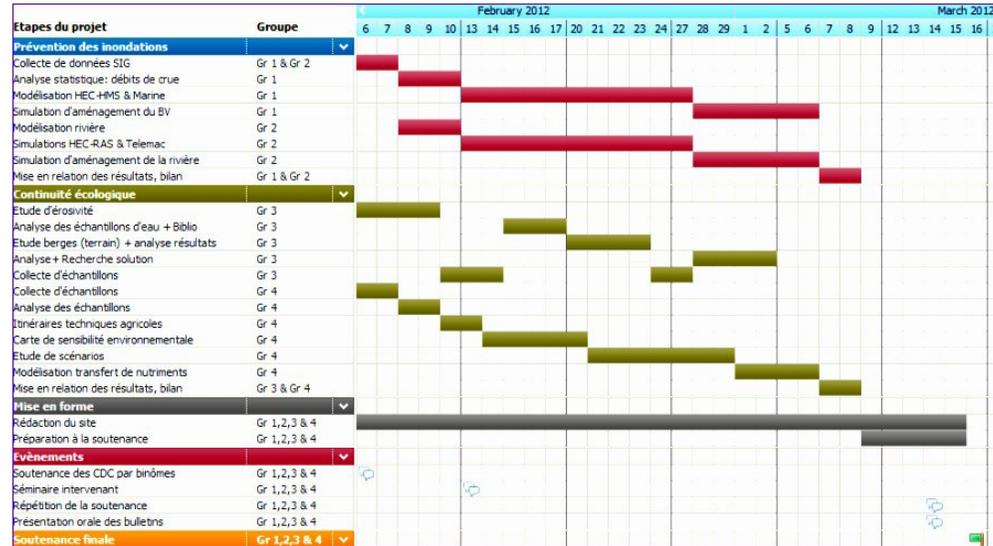


What if the contract is assumed?

- The Contractor/Trustee takes over performance of the work (i.e. continues performing) and must comply with the contract provisions and schedule going forward.
- But if the contractor is in default (11 U.S.C.A. § 365(b)(1)) :
 - The Contractor/Trustee must cure the default within 60 days or provide adequate assurance that it will be cured.
 - Compensate owner for pecuniary loss caused by the default
 - Provide adequate assurance of future performance under the contract

Working with an assumed contract.

- Establish the SOV
- Establish the remaining work
- Establish a schedule with firm deadlines
- Establish deadlines to report to the court.



It is important to always have a schedule in place. If the owner does not think that the contractor can meet its own proposed schedule, document the disagreement and accept the contractor's schedule. With a schedule in place, the stage is set for default for failing to meet a deadline.

Add milestones to the schedule to track and monitor progress.



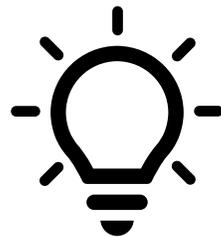
What are the owner's options if the debtor fails to perform?

- Contract Terms apply, but
- the owner must now seek permission from the court.
- A hearing will be needed.

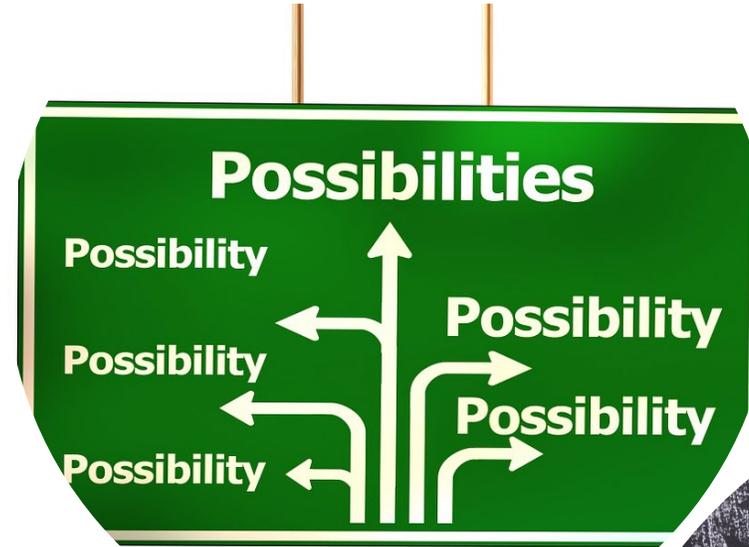


Available Options?

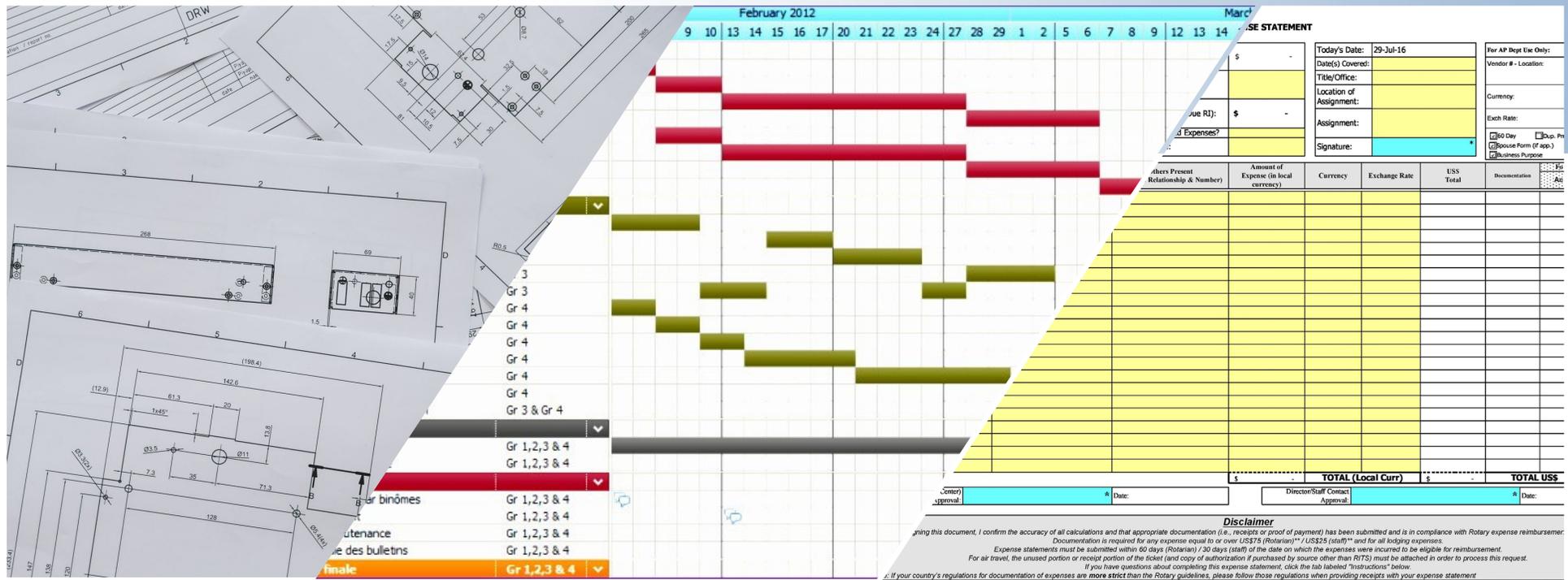
- Negotiate changes to the schedule, work, or costs with the Trustee.
- Seek permission to terminate the contract for convenience under Article 54.
- Seek permission from the Court to take over the work under Article 28.
- Seek permission from the Court to terminate the contract under Article 29.



Be prepared to defend your choice and explain how it benefits the debtor or bankruptcy estate.



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Contemporaneous Documentation is key!

- Contract Specifications
- Schedules Schedule Updates
- Daily Reports Expense Reports
- Meeting Minutes Payment Applications
- RFIs Change Orders
- Letters Emails
- Schedule of Values
- Recovery Schedules
- Regular Meetings
- PCOs
- Weather Reports
- Etc.

Article 54 – Termination for Convenience

Owner may at any time and for any reason terminate Contractor's services and work at Owner's convenience. Upon receipt of such notice, Contractor shall, unless the notice directs otherwise, immediately discontinue the work and placing of orders for materials, facilities and supplies in connection with the performance of this Agreement.

Upon such termination, Contractor shall be entitled to payment only as follows: (1) the actual cost of the work completed in conformity with this Agreement; plus, (2) such other costs actually incurred by Contractor as are permitted by the prime contract and approved by Owner; (3) plus ten percent (10%) of the cost of the work referred to in subparagraph (1) above for overhead and profit. There shall be deducted from such sums as provided in this subparagraph the amount of any payments made to Contractor prior to the date of the termination of this Agreement. Contractor shall not be entitled to any claim or claim of lien against Owner for any additional compensation or damages in the event of such termination and payment.

Requirements for termination of convenience in bankruptcy.

The owner must

- Move the Court for permission, provide justification, obtain permission, then:
 - Give Written Notice
 - Define in the notice the work, if any, to be finished before termination.
 - If there is no additional work, say so in the notice!
 - Be clear in the written notice. Do not make assumptions!
- The notice will likely need to be submitted to the court with the motion.



No Reason Needed – Without Cause

- A reason for termination should not be in the written notice.
 - Do not blame the contractor/debtor.
 - It is economical for debtor and owner to terminate rather than continue.
 - The debtor does not have to do any more work.
- This is not a default termination.

“No Fault” Divorce

The Owner and Trustee agree that this construction relationship is not going to work, and it is more economical if they should go their separate ways.

BUT, like a divorce, this will require money and compromise!



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The important questions:

- How much will this cost me?
- What are my liabilities?
- Are there better options?

How much will it Cost?

The debtor is entitled to:

1. Actual cost of the work completed in conformity
2. Other costs actually incurred ... as are permitted
3. Ten percent (10%) of the cost of the work in place
4. Refunds of bond premiums go to the contractor and would not offset any payments from owner

Simplified Example:

- \$50,000,000 project
- \$10,000,000 of work completed
- \$50,000 in pending COs & GCs
- \$6,000,000 paid to date

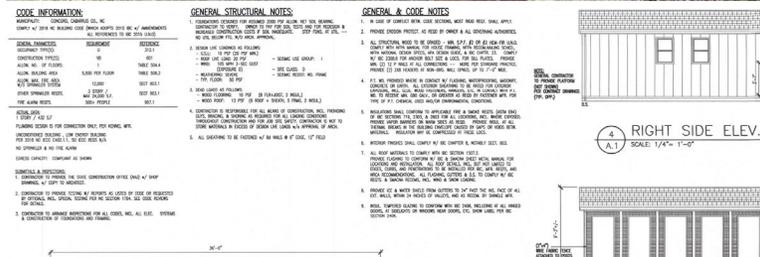
The base termination payment to the contractor: \$5,050,000.

- \$4,000,000 (unpaid work and stored materials)
- \$50,000 (for the “other costs actually incurred by Contractor”)
- 1,000,000 (10% of the \$10 Mil.)

How much will it Cost? Other Important Considerations.



Can the schedule tolerate it?



Is rebidding
Are there other
liabilities???

Just how much work has been done?

What are the owner's liabilities?

- Warranties
- Protection of the site and the public
- Utilities
- Compliance with environmental and other regulations
- Unknowns





What to Expect.

- **Easier if executed before construction begins.**
- **Some degree of project wind-down.**
- **Disagreements on pending change orders and cost.**
- **Prolonged negotiations if disagreements are severe.**

Art. 28: Owner's Right to do Work

If, during the progress of the work or during the period of guarantee, the contractor fails to prosecute the work properly or to perform any provision of the contract, the owner, after seven (7) days' written notice sent by certified mail, return receipt requested, to the contractor from the designer, may perform or have performed that portion of the work. The cost of the work may be deducted from any amounts due or to become due to the contractor, such action and cost of same having been first approved by the designer. Should the cost of such action of the owner exceed the amount due or to become due the contractor, then the contractor or his surety, or both, shall be liable for and shall pay to the owner the amount of said excess.



Requirements for taking over a portion of the work in bankruptcy.

The owner must

- Move the Court for permission, provide justification, obtain permission, then:
 - Give Written Notice to the Contractor
 - Send it by Certified mail, return receipt requested (sent by designer)
 - Define the work being taken over.
 - Give the contractor the required time to prosecute the work (fix the default).



Send the written notice to the surety as well. It may be liable!



Takeover Triggers

- Contractor fails to perform the work.
- Performs the work poorly or defectively.
- Contractor fails to comply with the contract.
- Using materials inferior to the specifications.
- Consistent failure to deliver a specific work item or items on schedule.



Important Considerations

- Do you have ample documentation?
- Have you followed the contract?
- Does the contractor have remaining work?
- Is the remaining work clearly defined?
- The contractor must be given an opportunity to right past wrongs.
- Work taken over cannot interfere with the original contracted scope of work.

What to expect?

- Disagreements about the cost of the work.
- Disagreements about design.
- Disagreements about money withheld.
- Disagreements about who caused delays.
- Dispute escalation. Time and money lost if it does.
- Regular reporting and accounting to the court.

Article 29 – Termination for Default

If the contractor fails to begin the work under the contract within the time specified, or the progress of the work is not maintained on schedule, or the work is not completed within the time above specified, or fails to perform the work with sufficient workmen and equipment or with sufficient materials to ensure the prompt completion of said work, or shall perform the work unsuitably or shall discontinue the prosecution of the work, or if the contractor shall become insolvent or be declared bankrupt or commit any act of bankruptcy or insolvency, or allow any final judgment to stand against him unsatisfied for a period of forty-eight (48) hours, or shall make an assignment for the benefit of creditors, or for any other cause whatsoever shall not carry on the work in an acceptable manner, the owner may give notice in writing, sent by certified mail, return receipt requested, to the contractor and his surety of such delay, neglect or default, specifying the same, and if the contractor within a period of seven (7) days after such notice shall not proceed in accordance therewith, then the owner shall, declare this contract in default, and, thereupon, the surety shall promptly take over the work and complete the performance of this contract in the manner and within the time frame specified.

Continued:

In the event the surety shall fail to take over the work to be done under this contract within seven (7) days after being so notified and notify the owner in writing, sent by certified mail, return receipt requested, that he is taking the same over and stating that he will diligently pursue and complete the same, the owner shall have full power and authority, without violating the contract, to take the prosecution of the work out of the hands of said contractor, to appropriate or use any or all contract materials and equipment on the grounds as may be suitable and acceptable and may enter into an agreement, either by public letting or negotiation, for the completion of said contract according to the terms and provisions thereof or use such other methods as in his opinion shall be required for the completion of said contract in an acceptable manner. All costs and charges incurred by the owner, together with the costs of completing the work under contract, shall be deducted from any monies due or which may become due said contractor and surety. In case the expense so incurred by the owner shall be less than the sum which would have been payable under the contract, if it had been completed by said contractor, then the said contractor and surety shall be entitled to receive the difference, but in case such expense shall exceed the sum which would have been payable under the contract, then the contractor and the surety shall be liable and shall pay to the owner the amount of said excess.

Triggers for Termination Failure to Work

1. If the contractor fails to begin the work under the contract within the time specified
2. If the contractor discontinues the prosecution of the work

Failure to Keep on Schedule

3. If the progress of the work is not maintained on schedule
4. If the contractor fails to perform the work with sufficient workmen, equipment, or materials to ensure the prompt completion of said work

Failure to Complete on Time

5. If the work is not completed within the time specified

Poor Quality of Work

6. If the contractor performs the work unsuitably
7. If the contractor fails to carry on the work in an acceptable manner for any other cause whatsoever

Fiscal Status as a Trigger for Termination

Possible

- The contractor becomes insolvent.
- The contractor allows a final judgment to stand against him unsatisfied for a period of forty-eight (48) hours..
- The contractor makes an assignment for the benefit of creditors.

Not Allowed

- The contractor declares bankruptcy
- The contractor commits any act of bankruptcy or

Requirements for termination for default in bankruptcy.

The owner must

- Move the Court for permission, provide justification, obtain permission, then:
 - Give Written Notice
 - Sent by Certified mail, return receipt requested,
 - To the Contractor and its Surety,
 - Of the trigger of default, AND
 - Give the contractor seven days to fix the issue.

The surety must

Promptly take over the work and complete the performance of the contract.

If the surety fails

- to take over the work within seven days, AND
- to notify the owner in writing by certified mail that it is taking over the work, AND
- state that it will diligently pursue and complete the same

Then the owner

shall have full power and authority to:

- take the prosecution of the work away from the contractor,
- use any or all contract materials and equipment on the grounds as may be suitable and acceptable and
- may enter into an agreement, either by public letting or negotiation, for the completion of the contract or use such other methods as in his opinion shall be required for the completion of the contract in an acceptable manner.

If the issue(s) are not fixed?

- The Owner Shall:
 - Declare the contract in default, and
 - Notify the surety of default.
- These are contract requirements, but the Court will also be involved.

Expenses

All costs and charges incurred by the owner, together with the costs of completing the work under contract, shall be deducted from any monies due or which may become due to said contractor and surety.

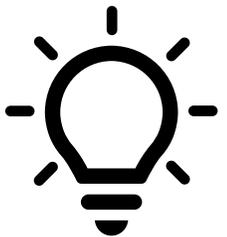


Expense < Contract Balance

the contractor and surety shall be entitled to receive the difference.

Expense > Contract Balance

the contractor and the surety shall be liable and shall pay to the owner the amount of said excess



Reporting and accounting to the court will be required.

Were the defaults documented?

- Contemporaneous documentation
- Via email or other written notes
- Schedules, daily reports, mtg. minutes, correspondence

Were the defaults material?

- Was the issue considered or treated as minor?
- Did the issue appear urgent from the records?
- Was scheduling enforced?

Was a schedule in place?

- Were regular CPM schedules required? With each pay app?
- Did deadlines pass without you noting or addressing them?
- Was a recovery schedule required? Enforced?

What were the causes of delay?

- Were RFIs and PCOs promptly addressed?
- Were requests for extensions promptly addressed?
- Were proposed schedules promptly reviewed and approved?
- Did the owner or architect issue any changes?
- Were there stop-work orders?
- Any other forms of possible owner delay?

How do courts view default termination?

- “Default-termination is a 'drastic sanction,' which should be imposed (or sustained) only for good grounds and on 'solid evidence.’”
- Termination is a draconian and drastic remedy, constituting a species of forfeiture warranting strict judicial construction and enforcement of the breaching party's pretermination rights to notice and an opportunity to cure breaches deemed sufficiently material to warrant contract termination by the nonbreaching party



Drawbacks to Default Termination

Wrongful termination is heavily penalized.

1. Termination becomes a breach of contract by the owner,
2. Anticipatory repudiation,
3. May convert to termination for convenience,
4. May discharge both the contractor and its performance bond surety from all performance obligations,
5. Exposes the owner to liability to the contractor for lost profits and other damages due to wrongful breach, plus possible pass-through expenses,
6. Extra-contractual damages where the termination decision is found not only to have been wrongful but made in bad faith, and
7. The owner may be liable for expenses and cost to the contractor and without the ability to offset its completion costs.

Numerous interdependent subcontractors and suppliers may be damaged, compounding the economic impact.

Drawbacks to Default Termination Cont.

Terminating the contract for default may allow the trustee to proceed with the verified complaint process and suit under NCGS 143-135.3(c)

The trustee may seek to bring an adverse proceeding within the bankruptcy.

The owner will be defending a suit while trying to complete its project.

The trustee may seek to prevent further work or expenses, in order to mitigate the Estate's exposure or to maximize its recovery.

Final thoughts on default termination in bankruptcy.

- It cannot be used without the court's permission.
- It should not be used unless the conditions are right,
- You can accept the risks, and
- There are no other viable options.



How does bankruptcy by a subcontractor or supplier impact a project?

- Same Issues as when a contractor is the debtor.
 - Cannot terminate the contract.
 - The contract must be assumed or rejected contract.
- The contract between the GC and Owner is NOT affected.
 - GC is responsible for on time delivery within budget, BUT
 - GC work may not be able to continue until the sub assumes or rejects.
 - GC may be subject to claims for delay and damages by owner and other subs
- The debtor's subcontractors also cannot terminate
- Subcontractors and suppliers may assert claims against the payment bond provided by the debtor or the GC.

Should the owner terminate before bankruptcy is filed?

- A contract that is validly terminated prior to the filing of the bankruptcy petition may not be assumed by the Trustee in the bankruptcy.
- If the cost to finish the work exceeds amounts withheld, then those costs will likely be an unsecured non-priority claim, and won't be paid.
- The owner is protected to some degree because there is a surety. If the contract is terminated before the Bankruptcy filing, and a demand is made upon the surety, the risk of completion is now on the surety.
- With monitoring of the project and the contract requirements, the ground for termination would have likely presented itself before well before the filing of the bankruptcy. But a well performing contractor may still find itself in bankruptcy.

Final Thoughts on Bankruptcy

- Actively monitor contract performance.
- Take action when and where needed.
- Respect the automatic stay.
- Know which Chapter it is.
- Determine work to be completed and the costs.
- Determine if the contract will be rejected or assumed.
- To communicate up and down the chain.

Questions?

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***This is not an opinion of the NC Attorney General’s Office, formal or otherwise. It has not been reviewed and approved in accordance with the procedures for issuing a formal Attorney General’s Opinion.**

Special thanks to:

The Attorneys at Conner Gwyn Schenck PLLC, authors of North Carolina Construction Law Treatise Available at: Westlaw and at <https://cgspllc.com/north-carolina-construction-law-treatise/>

