

## Low Man on The Totem Pole

### *Protective Options for a Subcontractor*

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Imagine that you are a subcontractor, and you just received notice that the general contractor on one of your projects is filing for bankruptcy protection. Or perhaps it's the developer or property owner who's out of funds. Either way, you have invested time, labor, and materials into a project that will probably never be completed, and your chances of collecting payment are getting slimmer with each passing day.

The frequency of this scenario has increased as both the economy and the construction industry continue to suffer. As more projects are abandoned, more subcontractors are being harmed.

#### **VULNERABLE SUBCONTRACTORS**

Subcontractors are the most vulnerable and exposed parties in the contractual chain. While a general contractor should be in regular contact with the developer or owner, a subcontractor is probably less in tune with the state of the project's funding, and is more likely to be blindsided by a bankruptcy filing. A subcontractor generally has two viable options to try to recover some of its investment in the project: it can

file a Mechanic's lien, and/or it can seek to collect on a payment bond.

There are many factors to consider in determining how to protect a subcontractor's interests. Though a subcontractor may want to take any project in this economy, it is worth keeping in mind that the same economy has caused many owners, developers, and construction companies to file for bankruptcy protection. Funds spent and monies recovered will go a long way to determining what steps to take. Putting good money into the "black hole" of legal proceedings must be heavily weighed before engaging in any of the following suggested pathways.

#### **MECHANIC'S LIENS**

The first step that a subcontractor should consider taking when it finds itself in a situation where it is not being paid is to explore its right to file a Mechanic's lien against the developer or property owner. A Mechanic's lien is a legal claim against the real estate by those who have supplied labor or materials that improve that property. It relates only to the real property and will not have any impact on other assets owned by the developer. Such a lien is specific to the real property where the work was performed. That is, it can become a lien against the real property, but is limited and subject to prior liens such as mortgages or judgments. The good news is that unless there is a bankruptcy filed by the owner, or in a case where a state receiver is appointed, no sale of the real property can occur without satisfying the Mechanic's lien.

When the general contractor has filed a bankruptcy, the automatic stay provisions of the Bankruptcy Code prevent a subcontractor from initiating any collection proceedings against the general contractor, but the stay does not apply to the subcontractor's lien rights against the property owner.

Even if the developer or owner files a bankruptcy, the subcontractor still has a right to file its lien, because the lien right is a state right that is not waived or stopped by the developer or owner's bankruptcy proceeding. A Mechanic's lien is therefore the subcontractor's first and best recourse in an attempt to get paid.

All contractors — whether general contractors or subcontractors — should be aware of the statutory deadline to file a Mechanic's lien. Subcontractors who fail to exercise their lien rights or miss the filing deadline are left with no recourse to collect funds from the owner/developer, unless they can make a claim against a payment bond.

Keep in mind that lien rights are unique to each state, so subcontractors should be aware of the particular laws governing each state in which they operate. The law that will control the subcontractor's lien rights is the law where the real estate is located.

#### **PAYMENT BOND**

The subcontractor can file a claim on the general contractor's payment bond, irrespective of whether it has the right to file a Mechanic's lien. A payment bond guarantees that first- and second-tier subcontractors and suppliers will get paid so long as they have met their obligations. Increasingly, developers and owners are requiring that their contractors carry bonds in an effort to guarantee that the project will not be derailed by a lack of funds. Since payment bonds are contractual agreements between the bonding company and the general contractor, each payment bond has its own requirements, including notice and filing deadlines. Before attempting to file a claim on the general contractor's bond, a subcontractor should review its scope of work on the project and determine whether its right to payment could

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be impacted by deficiencies in the work, delays, or other potential problems.

### **DON'T GET STUCK HOLDING THE BAG**

The best solution is always for the subcontractor to avoid the problem before starting work. It is recommended that the subcontractor take the following steps before embarking on a potential project:

#### **Carefully Screen the General Contractor**

Some subcontractors have a list of approved general contractors and only work with contractors who have a proven history of completing projects on time and on budget. Also consider whether the general contractor is the right fit for the project. Is the contractor experienced with this type of project? Does it typically operate in this region? Or is it stretching its capabilities to the limit? For example, a general contractor with experience in suburban residential building would likely not be aware of many of the issues involved in building a downtown high-rise, and could end up under-bidding the job. Likewise, a general contractor with experience in larger, urban developments might not anticipate zoning disputes, licensure problems, or local political issues when bidding a job, which could drive up the ultimate cost of the project.

#### **Ask if the General Contractor Is Bonded for the Project**

Request to see the bond and review it for the general contractor's bonding capacity. Do not rely on the word of the general contractor or its interpretation of any operative documents — the subcontractor should insist on reviewing them, or enlist the help of an attorney, before signing.

#### **Find Out Where the Project Financing Is Coming From**

Is the project funded by the government, or is it bank-financed? Is that line of credit going to be sufficient? Usually, the general contractor will already have asked these questions of the owner or developer, and should be able to pass that information on to their subcontractors. If not, or if the general contractor is reluctant to divulge such information, the subcontractor should ask to talk directly to the owner.

#### **Try to Anticipate Any Potential Problems**

Is the project timeline feasible? Are special materials required that could take longer to manufacture than the date that they are needed? Could a subcontractor whose performance is due before yours be in grave financial trouble, and could it cease operations, thus throwing off the timing of the project? Will there be an investiga-

tion into the legitimacy of a disadvantaged business enterprise, and will that delay a project or make completion more expensive for the general contractor? Any of these factors can cause delay or otherwise eat up costs, thus placing the general contractor, developer, and/or owner in financial danger and place the subcontractor's payment at risk.

#### **Be Wary of Any Contract That Requires the Subcontractor to Waive Its Lien Rights**

Even standard, seemingly boilerplate language which would have the effect of waiving lien rights could negatively impact a subcontractor's ability to file a Mechanic's lien. Instead of asking questions of the general contractor about a waiver of lien rights, consider marking up the language and returning it to the general contractor to see whether it is willing to negotiate the language. If the general contractor refuses to change the language, assess whether it would be worthwhile to risk working on the project at all. The subcontractor's lien rights are the best arrow in its quiver; it should never give them up without a fight.

#### **Try to Shift the Risk of Nonpayment from the Subcontractor to the General Contractor**

A subcontractor generally is more likely to get paid if the contract contains a "pay-when-paid" clause rather than a "pay-if-paid" clause.

- A "pay-when-paid" clause might read something like: "All progress payments *shall be made* within X days after payment is received by the General Contractor from the Owner."
- A "pay-if-paid" clause would include the condition that payment to the subcontractor only occurs the general contractor gets paid. A "pay-if-paid" clause might read something like: "The General Contractor's obligation to make a progress payment is subject to the *express condition precedent of payment* from the Owner."

While each state decides how these clauses are interpreted, many courts have held "pay-when-paid" clauses mean the general contractor is responsible for paying the subcontractor, even if the owner does not pay the general contractor. In other words, the general contractor bears the risk of nonpayment. A properly worded "pay-if-paid" clause, on the other hand, unambiguously shifts that risk to the subcontractor. Because this is a gray area subject to jurisdictional laws, counsel should assist a sub-

contractor in evaluating a specific contract payment clause.

#### **Keep Accurate and Thorough Records of the Labor and Materials Supplied on the Project on a Daily, if Not Weekly, Schedule**

In the event that the general contractor, owner, or developer files a bankruptcy, it could seek to recover payments made to the subcontractor within the 90 days prior to the bankruptcy, known as the preference period. A subcontractor should prepare information to show the ordinary course of payments between the debtor and the subcontractor, as well as any new value advanced to the debtor after the last payment was received by the subcontractor. Thorough compilation of this information will make it easier to prepare for and defend any preference litigation that may occur.

If the owner, developer, or general contractor does file a bankruptcy, the subcontractor should complete its Mechanic's lien process. Then, once the lien is properly filed, the subcontractor should file a proof of claim as a secured creditor in the bankruptcy case. The proof of claim can include interest at the appropriate statutory rate, if any.

#### **CONCLUSION**

At a time when most contractors are happy to take whatever work they can get, it might seem counter-intuitive to consider walking away from a project. But consider the alternative: submitting a bid, beginning work, fronting materials and labor costs, and ultimately ending up with little to no payment for those efforts. Worse yet, if the subcontractor does receive a payment for the project, and the general contractor or owner files for bankruptcy protection, the subcontractor could face a preference action for avoidance of the payments received within the 90 days pre-petition. When the alternative to not participating in a project is to sink money into the project that may ultimately be unreimbursed, the smarter move is to hunker down and keep an eye out for a better opportunity.

Since these decisions can be hard to make even in the best of times, savvy construction owners should seek the support of business advisers, including CPAs and attorneys, who can help them evaluate contracts and select projects with the best chance of being completed with full payment.