Strategies for Recovering Money from Troubled or Insolvent Owners

Presenters: Stephen B. Shapiro
Brian A. McDowell
Holland & Knight, LLP

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Learning Objectives

- Identify signs of owner financing trouble.
- Obtain strategies to manage risk associated with delayed payment.
- Obtain strategies for negotiations and workouts with the construction lender.
- Identify factors to consider when evaluating the position of construction liens.
- Identify practical effects of owner bankruptcy.
- Identify avoidance strategies in construction contract drafting.

Strategies for Negotiating for Payment with Owner and Lender




Current Challenges

- Factors Contributing to Owner Insolvency:
  - Owner default
  - Lender delays or resists funding
  - Insufficient financing in place to complete project
  - No new financing available
  - No new equity contributions

Current Challenges

- Owner Insolvency Shifts Risk of Nonpayment to Contractors
- Other complicating factors:
  - Owners set up as Special Purpose Entities
  - Devaluation of Real Property (security)
  - Bankruptcy of Owner

Special Purpose Entities (SPE)

- Often preferred by Lenders
- Purpose of the SPE is to insulate the SPE's owners from liability to project creditors *but also* to protect non-project creditors from project assets
- Single-asset business entity created exclusively for the project
- SPE will have no significant assets other than the project itself

Special Purpose Entities (SPE)

- In most cases, a Contractor will only be able to look to the assets of the <u>SPE</u> for payment of amounts owed.

- The SPEs owners will generally <u>***not***</u> be liable to the Contractor or other project creditors.

Special Purpose Entities (SPE)

- When Owners of SPE Can be Liable for Project Debts:
  - General Partners
    - A general partner is usually personally liable for the debts of the partnership, so a project creditor can look to the assets of the general partner as well as the assets of the Project Owner for payment.
  - Guaranty Liability
    - An individual or business entity promises to pay the debts of another in the event of nonpayment
    - Only the creditor to whom the guaranty is given may enforce the guaranty and collect payment

Special Purpose Entities (SPE)

- Other circumstances when Project Creditor may be able to look beyond Project Owner for payment:
  - Co-mingling of funds between Project Owner and another individual or business entity
  - Inadequate capitalization of the Project Owner
  - "Fraudulent Transfer" of assets from an insolvent Project Owner to another without receiving equivalent value <u>or</u> for the purpose of frustrating a creditor

Devaluation of Real Property

- Devaluation of real property means that <u>everyone</u> has less security in the event of Owner default

- If the Lender forecloses, the game is over

Lien Priority

- As real estate values have declined, lien *priority* has become a critical issue
- Priority of construction liens in relation to other liens, mortgages or conveyances is determined by state law
  - Generally, the rule of “first in time, first in right” will dictate lien priority
  - But many states allow all properly recorded construction liens to “relate back” to the commencement of the project

Lien Priority

- Generally, the construction lenders will have recorded their mortgages before the commencement of construction and will have *priority* over construction liens
  - The first mortgage or lien holder has a right to be paid in full from the proceeds of the property before the next mortgage or lien holder can take any payment
  - This means that, if the construction loans equal or exceed the value of the property, a construction lien may have no effective value

Lien Priority

- Special Considerations that may effect the lender's priority
  - Failure to properly record
  - Inequitable conduct by lender during course of project

Lien Priority

- Equitable Subordination and Equitable Liens
  - If the lender engages in inequitable conduct that gives the lender an advantage at the expense of a junior lienor, the lender's lien may be subordinated to the junior lien

Recovering Directly from Construction Lender

Lender Liability Under State Law

- In some states, lenders may be statutorily required to provide contractors with notification upon default of a Project Owner or in the event that the lender ceases funding

Recovering Directly from Construction Lender

- Equitable Lien on Undisbursed Loan Proceeds
  - In some circumstances, a contractor may have a right to place a lien on any undisbursed loan proceeds

Recovering Directly from Construction Lender

- Other special circumstances that may provide the construction lienor with leverage:
  - Condominium Projects - Depending on state law, construction lienor may be able to enforce the lien against condominium unit purchaser

Owner's Bankruptcy

- Bankruptcy is an option for many insolvent Project Owners
- Bankruptcy case is usually commenced by the debtor filing a voluntary bankruptcy petition
  - But there are circumstances where creditors can put a debtor into an "Involuntary Bankruptcy"

Owner's Bankruptcy

- "Automatic Stay"
  - Effective immediately upon filing of bankruptcy petition
  - Prohibits all efforts to collect payment from the debtor without permission from the Bankruptcy Court
  - Courts <u>will</u> enforce the automatic stay

Practical Effect of "Automatic Stay"

- Unless you receive permission from the Bankruptcy Court, a contractor <u>cannot</u>:
  - Take or demand payment from debtor
  - File or continue to litigate any state or federal lawsuit against the debtor
  - Execute a Judgment against the debtor

Practical Effect of “Automatic Stay”

- But a Contractor <u>can</u>:
  - Make a claim against debtor’s surety
  - Make a claim against a guarantor that is not the debtor

- And depending on the circumstances, a Contractor <u>may</u> be able to:
  - Record a claim of lien against the debtor/Owner’s property

Owner's Bankruptcy

- A Construction Lien gives Contractor a "secured" claim in the Bankruptcy case, significantly increasing chance of being paid
  - But, there must be enough value in the property to cover Contractor's lien and any prior liens
  - If there is insufficient value in the property to cover the Contractor's lien, some or all of the Contractor's claim will likely be treated as unsecured.

Strategies for Minimizing Risk on New Projects

Due Diligence

- Understand the structure of the project financing and the construction loan(s) <u>before</u> you sign the contract
  - Triggers for loan default by Owner
  - Seniority of the debt
  - Contractor's position relative to the debt hierarchy

Due Diligence

- Other questions to ask:
  - How does the Owner plan to repay the loans?
  - How well secured is the Lender?
  - Is the Owner willing or reluctant to share this information?
  - Are you comfortable extending credit to the Owner?

Key Contract Terms

- Evidence of Adequate Financing
  - Ensure that Contractor has the right to demand evidence of adequate financing during the course of the project
    - Exercise this right when "red flags" appear and prior to performing large change orders
    - Can help create relationship between Contractor and Lender that may be helpful down the road

Key Contract Terms

➢ Pay-If-Paid / Pay-When-Paid Clauses

- If enforceable in your state <u>and</u> drafted properly, these clauses allow a Contractor to delay payment to subcontractors or suppliers until payment is received from Owner
- If not drafted effectively, Courts will interpret the clause to require payment to the subcontractor or supplier within a reasonable time after work or material was furnished – regardless of whether payment has been received from Owner

Key Contract Terms

- Clear the Decks of Contract Language that Allows Owner to Avoid Responsibility for Payment or Performance Based on Lender's Actions
  - Example: Don't let Owner avoid payment obligations in the event that Lender does not fund draw

Key Contract Terms

- Streamline Payment Approval Process

  - If Architect has not approved payment application within 7 days, require that Architect provide written explanation

  - Or, remove Architect from approval process altogether

Managing Risk During the Project

- Exercise rights under the Contract to demand proof of adequate financing
- Carefully prepare payment applications in compliance with contract requirements to limit delay in payment
- Enforce contract provisions related to Change Orders – don't let Owner abuse Construction Change Directives

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