

## Dealing with developer insolvencies

Contractors need to be proactive to ensure that they get paid in lien cases

Developer insolvencies are unfortunately becoming more and more common in our current economic climate and often result in partially completed projects being stopped. The consequences to contractors can be significant. A number of recent resort projects illustrate what the contractors and subs can typically expect.



### CONSTRUCTIVE ADVICE

Kenneth Childs

First, the obvious, immediate problem is nonpayment, which in turn requires the contractor to file a lien. In Oregon, after a lien is filed, the contractor has 120 days to file a lawsuit to foreclose it. The commencement of the foreclosure suit is only the start of what can sometimes turn into a long and drawn-out battle with an uncertain outcome.

If the project involves conventional bank financing, as many do, the biggest battle will be between the contractor and the bank. If the contractor has prepared its lien properly, it will normally have priority over the bank. While in some cases the contractor may be successful in moving the case along quickly, it's not at all uncommon for such cases to drag on for a year or more, and this will likely be the situation if there are significant priority disputes.

In other economic climates, banks would often step up and pay off the construction liens, once any priority issues were resolved; however, that is not happening as often in the current climate for a number of reasons. First, many banks are dealing with their own insolvency issues, and some are operating under Federal Reserve supervision. Banks in those situations are often incapable of advancing new funds. Second, as a result of the recent significant decline in real estate values, the equity cushion that many banks thought they had when making the loan has disappeared. Without any equity to protect, many banks will elect to simply abandon their collateral to the construction lien claimants. And third, participation loans have become more common. The result is that the lender on a particular project might not be an individual bank, but instead a collection of banks, perhaps as many as 40 or 50. Negotiating with a single entity presents a different dynamic from negotiating with a committee.

In the course of the lawsuit, the contractor is obligated to the subs and suppliers. If the subcontracts contain pay-if-paid or pay-when-paid provisions, the general contractor may be protected, though not necessarily. Recent case law has held that a pay-when-paid provision still obligates the general contractor to pay subcontractors within a reasonable period of time and does not permit the general contractor to delay subcontractor payments indefinitely.

Assuming the general contractor succeeds in being awarded a judgment in the lawsuit, the next step is to schedule a foreclosure sale, and this can be done within approximately two to three months after a

**Payment defaults can cause contractors significant delays. It's important to anticipate payment issues at the contracting stage and to monitor the issues closely during performance.**

judgment is entered. If the bank has not stepped up and paid subcontractors by the time the foreclosure sale is scheduled, there is a good chance that it will not do so and will instead allow the sale to go forward. If the sheriff's sale takes place, the bank is still protected, because it can later exercise its redemption rights to acquire the property for the amount that was bid at the sale.

However, if the owner believes there is equity in the project, and most owners are optimistic that there is, even in the face of an appraisal to the contrary, the owner will file a bankruptcy petition in time to prevent the sale. If the owner is a single-asset limited liability company, a bankruptcy filing is an easy decision. Typically, the owner will wait to file the petition until only a day or two prior to the scheduled foreclosure sale.

In bankruptcy, the owner will likely propose a plan of reorganization that involves delaying completion of the project for a few years until the economy turns around, which will, in theory, give the owner time to locate new financing, complete the project, and pay everyone off. All of this, of course, means the contractor won't get paid for years. Many contractors simply cannot wait that long.

The contractor can do a number of things to prevent this situation from happening. First, the contractor can investigate the owner's financial condition before starting work. This might involve asking for financial statements, requesting confirmation from the lender that the financing has been approved, and ordering a Dunn & Bradstreet report. If there are concerns, the contractor should request that the owner post a payment bond. Second, the contractor should include strong language in the contract allowing it to stop work for nonpayment and to demand financial assurances in the event it has reason to question the owner's solvency. Third, assuming that it has included strong language in its contract, the contractor should exercise its right to stop work promptly in the event of nonpayment. Fourth, the contractor should insert pay-if-paid provisions in its subcontracts. And finally, the contractor should act promptly and cautiously in filing its lien.

Payment defaults can cause contractors significant delays. It's important to anticipate payment issues at the contracting stage and to monitor the issues closely during performance.

*Kenneth P. Childs is an attorney in the construction and design practice group at Stoel Rives LLP. Contact him at 503-294-9409 or [kpchilds@stoel.com](mailto:kpchilds@stoel.com).*