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Real Estate & Construction News
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BANKRUPTCY & CONSTRUCTION

As if keeping a project on budget and on time is not enough, more and more in today's economic climate the proverbial monkey wrench of bankruptcy is being thrown into the myriad of construction issues owners, contractors, and subcontractors face on construction projects. In blunt terms, while bankruptcy may be a mechanism to provide a "fresh start" to a financially troubled entity, its effect on others is quite the opposite.

Bankruptcy takes various forms based on the particular chapter of the bankruptcy code invoked by the party seeking protection ("debtor"). Chapter 7 is known as a liquidation and is invoked when there is no chance of the debtor continuing its business. Under a liquidation, the assets of the debtor ("property of the estate") are distributed to creditors based on the priorities established by the bankruptcy code. Chapter 11 for a business (Chapter 13 if an individual) is a reorganization in which the debtor develops a plan to organize its finances and operations to stay in business. The plan must be approved by the court and the creditor's committee. The committee is made up of representatives of the various categories of creditors. During the reorganization process, the debtor has the ability to assume or reject executory contracts, that is contracts where the parties still owe obligations to one another.

The key protection afforded by filing a bankruptcy petition is the imposition of an automatic injunction preventing creditors from taking action against the debtor and its property. This is known as the "automatic stay." While it is provided to give the debtor an opportunity to determine how to administer its assets, reciprocally, the automatic stay may be extremely disruptive to the construction process. As such, understanding some of the basics of bankruptcy may enable construction participants to mitigate the problems.

Another key component in bankruptcy is determining what assets are "property of the estate". If the asset is property of the estate, then the bankruptcy court has control of the asset. Simply because the debtor is in possession of cash proceeds does not automatically result in a determination that such cash is property of the estate. For example, if a general contractor files for bankruptcy protection, a subcontractor or material supplier may argue that construction proceeds paid by the owner to the debtor contractor are not property of the estate. In those states which have enacted builder's trust fund statutes, and the statute is sufficient to create an express trust, i.e. that the contractor is holding construction proceeds in trust to pay subcontractors and suppliers, the bankruptcy court is likely to determine that such funds are not property of the estate and allow distribution to the unpaid subcontractor or supplier.

Unfortunately, Pennsylvania has not enacted a builders trust fund statute; however, an unpaid subcontractor or supplier may argue the existence of a "constructive trust" if they can show a sufficient equitable interest in the proceeds which are in the possession of the debtor. A lower tier subcontractor or supplier may find it beneficial to add language to their contracts in which the funds are held in trust by the contractor to avoid the bankruptcy court gaining control of contract proceeds. An important factor considered by the bankruptcy court in enforcing such trust language is that the trust

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To speak with any of our attorneys,
Call 412.242.4400
or email
acm@mbm-law.net

agreement must create a trust at the time the money comes into the possession of the debtor rather than creating a trust in the event the contractor misapplies the funds to another debt.

Joint check agreements do not always protect lower tier entities from those funds being grabbed by the estate of the debtor. In order for a joint check agreement to remain outside the debtor's estate, the agreement must include language creating an express trust. Many unilateral letters of instruction from the debtor, which may be revoked at will, are insufficient to create an express trust. Other construction security or financing devices typically remain outside the property of the estate. For example, performance bonds and payment bonds issued on behalf of the debtor as principal will be treated as independent obligations of a bonding company and not part of debtor's estate. Letters of credit, sometimes issued to assure performance of construction, are also typically considered to be outside the debtor's estate. These instruments, therefore, provide a creditor recourse for collection outside the bankruptcy courts.

If the bankruptcy debtor is the owner, construction participants have alternatives to distributions through the bankruptcy courts. The most common is the mechanics' lien. This statutory lien created by statute is not a lien against the contracting party, but a lien on the real property improved by the contractor's goods or services. If the property is owned by the debtor, the automatic stay will prohibit the enforcement of a lien, but it will not prohibit a party from perfecting the lien (filing the claim).

Other problems arise with bankruptcy. Understanding that the goal is to maximize the size or amount of debtor's estate, which ultimately benefits creditors, some of the actions to build the estate may single out otherwise innocent parties. One of these instances arise in a Chapter 7 liquidation where the trustee of debtor's estate seeks to avoid a transfer made by the debtor within 90 days of the petition date as a preference. A finding of a preference would require the return of property to the debtor's estate if the transfer was made by the debtor while it was insolvent and enabled the creditor to receive more than it would have received in the Chapter 7 liquidation.

Earmarking is a defense used against a preference action. This defense is available if the debtor used borrowed funds to satisfy a pre-existing debt. If the borrowed funds were to be used for a specific purpose of paying a creditor of the debtor, the funds are not treated as part of the estate and not subject to a preference action.

While there is little to prevent a bankruptcy by a construction participant, there may be steps creditors can take to minimize the impact. Understanding the process or retaining counsel that understands the process may serve to minimize the impact and provide recourse to funds not encumbered in bankruptcy.

SBA LOAN PROGRAM PROPOSALS

On February 5, 2010 the White House proposed the expansion of two Small Business Administration (SBA) loan programs to help increase small business working capital and help small businesses refinance maturing debt.

According to SBA Administrator Karen Mills, the tight credit market of the last two years has cut lines of credit for small firms. Raising the limit on SBA Express loans from $350,000 to $1,000,000 would give small business owners quicker access to a source of capital to restock inventories and create jobs. SBA "small business" size standards vary based on the business' industry type, maximum annual receipts (ranging from .75 to 33 million) and/or maximum number of employees (ranging from 50 to 1,500), and are generally classified by the SBA using NAICS (North American Industry Classification System) codes. Program specific size standards may also apply.

In addition, the White House proposed expanding the SBA's 504 loan program to temporarily allow for the refinancing of owner-occupied commercial real estate. According to Ms. Mills "thousands of good, creditworthy businesses find themselves caught with declining real estate values…many of them facing mortgages coming due in the next few years." The SBA 504 loan program currently is limited to financing for new development or construction and for a limited amount of refinancing for use solely when businesses are expanding.

The qualifications and details for the proposed 504 loan program modifications, posted by the SBA, include:

Program Structure (follows existing 504 program):
- 50% or more by commercial first mortgage (private lender, no government guarantee);
- Up to 40% SBA backed guaranty;
- At least 10% borrower equity

Eligibility (mirrors existing 504 program):
- Small business qualification (that cannot obtain credit elsewhere);
- Eligible collateral (owner-occupied real estate, fixed assets); and
- Existing mortgage, currently performing (not in default), maturing in one year.

Debenture Size: up to $5 million/$5.5 million for manufacturing

Refinancing Parameters:
- 90% refinance of current appraised value or 100% of outstanding principal (whichever is lower) plus allowable closing costs;
- 70% LTV required for same institution debt refinance, 50% for new institution (ie, a same institution refinance would only qualify for a 20% SBA backed debenture)
- Either 10 or 20 year term
- Lenders to write down or subordinate any debt in excess of the financing limits

New legislation is required to implement the above proposals.

Contact the real estate team at Maiello Brungo & Maiello to discuss SBA loan programs and qualifications.

PREMISES LIABILITY ASSAULT & BATTERY EXCLUSION

When reviewing your commercial general liability coverage with respect to premises liability concerns, check for the assault and battery exclusion, and whether this is a concern with respect to your business operations. "Assault and battery" generally means violence toward a victim, whether by staff, invitees or other third persons. Property owners and operators are frequently sued by the victim when violence occurs on or near their premises, often under a theory of negligent provision of security, negligent hiring, and/or negligent supervision.

When a commercial general liability insurance policy contains an assault and battery exclusion, the policy may not cover a claim for injuries arising out of an assault and battery, even if the insured is found liable under a legal theory of negligence. Pennsylvania courts (and courts in multiple states) have held that a claim which arises from a physical attack is not covered under a policy with an assault and battery exclusion, even where negligence is alleged in the complaint, because the claims arise from the physical injuries caused by the assault and battery. *Victoria Ins. Co., v. Mincin Insulation Services, Inc.*, 2009 U.S. Dist. LEXIS 84082 (W.D. Pa. September 15, 2009).

This policy exclusion is found most commonly in liquor liability, or 'dram shop' policies, or in high risk, surplus line insurance policies. It may be possible to obtain coverage, or an endorsement modifying the exclusion, if the insured requires coverage over such incidents.

MB&M can assist in reviewing your policy coverage, and analyzing and explaining your premises liability risks and concerns.

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EMPLOYMENT SEMINAR

Maiello, Brungo & Maiello has partnered with the University of Pittsburgh Small Business Development Center (SBDC) to present an Employment Seminar geared for small businesses. MB&M's Employment & Labor Law Team will speak on effective hiring and firing, developing employee handbooks and use of independent contractors. For further information or to reserve a space, please contact Lisa at ll@mbm-law.net.

Friday, May 21, 2010 • 7:30 to 10 a.m. • $25 • Mervis Hall
University of Pittsburgh Campus, Roberto Clemente Drive, Pittsburgh, PA 15213

The MB&M Real Estate & Construction Law Team:

Alfred C. Maiello	acm@mbm-law.net
Lawrence J. Maiello	ljm@mbm-law.net
John H. Prorok	jhp@mbm-law.net
David Raves	dr@mbm-law.net
Kathleen C. McConnell	kcm@mbm-law.net
Jennifer L. Cerce	jlc@mbm-law.net
Donald A. Walsh, Jr.	daw@mbm-law.net

To speak with any of our attorneys, call 412-242-4400.

MORE ABOUT THE SBDC AND MB&M PARTNERSHIP

The University of Pittsburgh SBDC offers assistance through programs, services and specialized support to entrepreneurs and small businesses. Maiello, Brungo & Maiello are the exclusive legal sponsor to the University of Pittsburgh SBDC First and Second Step programs where John Prorok and Lawrence Maiello educate small business owners on the Mechanics of Starting a Small Business and Developing a Business Plan. Classes run year round at the Oakland campus.

For dates or further information, please visit the seminar and event section of www.mbm-law.net or http://www.entrepreneur.pitt.edu/sbdc/sbdc_events.php