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Who has priority rights to construction funds when a player on the project goes belly up?

INSIGHTSARTICLE

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Cash flow on a project is the oil that keeps the machine running. Unfortunately, sometimes one of the players on the project — an owner, higher-tiered contractor or subcontractor — runs into cash issues, becomes insolvent or files for bankruptcy. This can lead to many problems and issues on a project. Here, we look closely at a specific issue: Who has rights to the construction funds that were allocated for the construction project?

Depending on the jurisdiction and specifics of the project, those who are furnishing labor and materials to the project have a strong argument that they have priority rights to the construction funds. This is because of equitable doctrines, such as equitable liens, which give priority rights to the contractors/subcontractors/materialmen that invested labor and materials to the project for which the funds have been earmarked. Similarly, in some states, by statute, construction funds might be held in trust for those who furnished the labor or materials. These legal doctrines can be of significant importance if there is a fear that a higher-tiered contractor or owner will use the funds for other creditors. Likewise, it can be applied to protect a higher-tiered contractor or owner who desires to allocate funds for laborers and materialmen, in the circumstance where a third-party creditor seeks to attach the construction funds for an unrelated debt.

Priority rights to the specific construction funds is not the only remedy to consider. Contractors, subcontractors and suppliers may have rights to file mechanics' liens, claims on bonds and also breach of contract actions.

A complicated problem that can be addressed in various approaches

Instances of cash flow problems tend to be fact-specific, and each instance will have unique wrinkles. Still, there are typical approaches to addressing these risks:

- Prequalifying the project finances and your contractual relationships
- Negotiating for proper contractual rights and remedies to allow for financial information upon request and the right to act promptly to protect oneself in event of problems
- Closely monitoring the project and relationship to address any issues of cash flow
- Acting promptly to investigate and respond to any issues

Handling these complex issues often requires a balancing of risk, legal rights and preferred business approaches. It is recommended that construction companies regularly update and revise their contract terms and negotiation points to ensure proper protections going into projects. When issues arise on a project, it is further recommended to act promptly to assess legal rights and respond to the situation. As always, it is important to use trusted legal counsel and also receive feedback from related professionals such as insurance and bonding brokers, as well as accountants.

Saxton & Stump attorneys Ron Pollock and Matt Chabal are available to discuss approaches to these types of issues, whether in the nature of contract negotiations and standard terms, or project specific disputes and issues that may require litigation.

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