



## IT MAY PAY FOR SUBCONTRACTORS TO GET AGGRESSIVE

In contractor bankruptcies, some creditors have stronger claims than others

By **WALLY ZIMOLONG**

**B**ankruptcy is difficult for general contractors, but it is often harder on the debtor's subcontractors. The debtor's failure to pay, coupled with already tight margins and slow payments on the best of projects, can result in a subcontractor facing its own cash-flow nightmare.

Because they generally are ordinary unsecured creditors, most subcontractors file a proof of claim for their unpaid bills and resign themselves to receiving a fraction of their claim, if anything, at some time in the future. However, prevailing case law suggests that this may not be the correct approach.

Since the U.S. Supreme Court's 1962 decision in *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962), a case on appeal from the 2nd Circuit, federal courts have recognized that money held by an owner from a debtor who has failed to pay its subcontractors is not property of the bankruptcy estate. In *Pearlman*, a dispute arose between the trustee and a payment bond surety over funds retained by the construction project's owner, the federal government. In constructing what has become known as the *Pearlman* doctrine, the Court held that not only were the retained funds not property of the bankruptcy estate, but also that unpaid subcontractors had a right to be paid directly from the retained funds.

The 2nd Circuit adopted the *Pearlman* doctrine in *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d 747 (1987). There, the Court of Appeals reinforced the *Pearlman* doctrine and granted subcontractors a "super-priority" in funds held by an owner when it held that "[i]t is not new law that unpaid subcontractors

hold an equitable interest in a contract balance owed by a building owner to a general contractor." In so ruling, the Court of Appeals reinstated the plaintiff subcontractor's direct claim against the owner, the U.S. Postal Service, for payment of money owed to it by a debtor contractor.

### Superior Right

Additionally, state courts have shown a willingness to apply the *Pearlman* doctrine to interpleader actions involving claims to retained contract funds. Recently, the Pennsylvania Superior Court applied the *Pearlman* doctrine in *Trevdan v. Toll Brothers Inc.*, 2010 PA Super. 100, holding that an unpaid subcontractor had a right superior to that of a secured creditor to funds retained from a bankrupt contractor.

The debtor in *Trevdan* listed the funds withheld by Toll Brothers as an asset of the estate and a secured creditor obtained relief from the automatic stay to pursue the retained funds in Pennsylvania state court. *Trevdan*, a subcontractor of the debtor, challenged the secured creditor's right to the retained funds. Relying on the *Pearlman* doctrine, the Pennsylvania Superior Court found the right of the debtor's unpaid subcontractor to the Toll Brothers funds was superior to that of the secured creditor and held that "[s]imply stated, as an unpaid materialman, *Trevdan* holds an equitable lien against the contract funds Toll Brothers withheld during the construction project." The Superior Court continued, stating "we find the [debtor] lacks

a cognizable interest in the contract balance that the owner, Toll Brothers, interpleaded into the court."

Thus, a creditor subcontractor in a bankruptcy proceeding or in an interpleader action has precedent to aggressively pursue unpaid contract balances withheld by an owner from the debtor prime contractor.

One suggested strategy for a subcontractor pursuing a claim is to bring an advisory claim seeking declaratory — and perhaps injunctive — relief, which asks the Court to rule that the funds held by the owner are not property of the bankruptcy estate pursuant to the *Pearlman* doctrine. Another approach would be to pursue directly the owner withholding the money or at least make demand upon the owner for direct payment of such funds.

On the other hand, project owners holding monies due to debtor general contractors must be aware of the potential claims by unpaid subcontractors to any money so retained. Therefore, owners should consider initiating an interpleader action regarding the retained funds in order to limit their liability. ■



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