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Don't get soaked

Bankruptcy is an unfortunate fact of life. In the current economic climate, construction companies may be faced with project owners or developers that file for Chapter 7 (liquidation) or Chapter 11 (reorganization) protection. To protect yourself in such cases, here are some tips for maximizing your chances of getting paid.

Why you need a plan

It's a good idea to have a plan in place *before* an owner files for bankruptcy, so you can act quickly to preserve your rights. For example, under certain circumstances, you can "reclaim" materials supplied to an owner shortly before bankruptcy or obtain a priority-status claim for their value. To enjoy these advantages, however, you must present your claim within a short time after the bankruptcy filing.

How to secure your position

Generally, in bankruptcy, secured creditors get paid first and whatever's left is divided among the unsecured creditors. So obtaining a security interest in the project or other assets of the owner provides a big advantage. One way to accomplish this is to file a mechanics' lien.

If you continue to work on a project for an owner that has filed for Chapter 11 protection, take steps to protect your right to payment for current work.

Another option is to ask the owner for a security interest in real estate, equipment or other assets. Under ordinary circumstances, owners are reluctant to grant such interests, but a financially troubled owner may be willing to do so to retain your services. Or, consider asking the owner's principals to personally guarantee payment.

As you explore your options, be mindful of the "automatic stay." The stay operates automatically upon the filing of a bankruptcy petition, prohibiting creditors from pursuing any collection activities without the bankruptcy court's permission.

In most states, you can file a mechanics' lien against an owner even after it has filed for bankruptcy. That's because a mechanics' lien generally is created when you perform work on a project or deliver materials to the site. Filing it with the county recorder and serving it on the owner (if required) merely "perfects" the lien.

You should also understand the bankruptcy law's "preference" rules. A preference is a payment by a debtor to a creditor on a previous debt (including certain transfers of security interests) made while the debtor is insolvent and within 90 days before the bankruptcy filing (one year for creditors who are "insiders"). The bankruptcy trustee can nullify these payments and recover the funds from the creditor. To avoid preference claims, take steps to secure your position, obtain personal guarantees or make other collection efforts at the first sign of financial distress.

Understanding bankruptcy estates

When an owner files for bankruptcy, its assets go into the "bankruptcy estate" and are protected by the automatic stay. In some cases, it's possible to get paid from assets that aren't part of the bankruptcy estate. For example, you may be able to demand immediate payment on a personal guarantee.

Also, some assets may be considered trust funds, which aren't the owner's property. Depending on state law, the proceeds of certain construction loans and government grants used to finance construction work may constitute trust funds that the owner must use to pay contractors and suppliers. If you can show that specific assets are trust funds — or you can trace them back to trust funds — you may be able to keep these assets out of the bankruptcy estate and increase your chances of recovery.

When to step in

If you continue to work on a project for an owner that has filed for Chapter 11 protection, take steps to protect your right to payment for current work. Although the automatic stay and preference rules prevent you from collecting prebankruptcy debts, they don't apply to work that you perform or materials you furnish while the case is pending.

To protect your interests, monitor the bankruptcy proceedings and be sure that your claims against the owner are properly listed and classified (as secured, for example). Keep your eyes open for assets that were improperly excluded from the bankruptcy estate and for recoverable payments to other creditors. These include payments on prebankruptcy debts as well as overpayments on current debts that you suspect may be disguised payments for old debts.

No picnic

Owner or developer bankruptcies are no picnic for anyone — especially contractors. As mentioned above, having a plan for this unfortunate and all-too-common eventuality can lessen its negative impact. To maximize your recovery, be sure to consult a bankruptcy attorney. ■

Want to avoid court? Try ADR instead

Disputes arise in all types of business. But they can be particularly nasty for construction companies, because there are so many entities trying to get paid for projects fraught with risk. Yet such disputes can often be resolved more easily and quickly if they avoid litigation altogether.

A variety of alternative dispute resolution (ADR) methods offer effective ways to address different degrees of conflict severity. And they're all worth a try under the right circumstances.

Negotiation

In this process, two or more disputing parties meet to identify and discuss the issues with the intention of arriving at a mutually acceptable solution. Unless an impasse develops, the parties are responsible for settling their differences without

outside help. Negotiated settlements often end amicably because the parties are willing to cooperate to attain a mutually acceptable solution.

Mediation

With mediation, parties submit their dispute to an impartial mediator who coordinates one or more private proceedings to produce a settlement. Although the mediator acts as an advisor, resolution ultimately rests with the parties — a mediator can't impose a settlement.

Mediation begins when either you, the opposing party or the presiding judge requests it. A court may appoint the mediator, or you and the opposing party may select him or her through an independent mediation association. After selection, the mediator arranges the first meeting and clarifies the issues.

When all else fails

Sometimes, it's impossible for parties to agree — even after trying an alternative dispute resolution (ADR) method. (See main article.) At this point, it's time to go to court to settle the dispute. Here a judge or jury hears witnesses, reviews evidence, weighs the facts and issues a legal decision. The losing party may appeal the decision to a higher court.

Litigation begins when you or your opponent files a lawsuit in state court. The court assigns the case to a judge who holds a preliminary hearing. Both sides later file motions and the judge sets a trial date. The judge or a jury will hear the case and hand down a decision or verdict. The losing party can appeal the decision to an appellate court, and whoever loses there can then usually appeal to the state's supreme court.

Arbitration

The arbitration process begins when parties submit a dispute to one or more impartial persons with construction-business expertise. The disputants mutually agree to the range of issues, procedures and the scope of relief to be awarded. Arbitration hearings are usually private and less formal than court proceedings. The courts review or overturn few arbitration awards because parties usually agree that the arbitrator's decision will be binding.

During the hearing, the arbitrators hear testimony and review submitted documents. When finished, the arbitrators issue a binding decision within 30 days. If you win, you present the award decision to a court, which will issue a judgment in your favor. Arbitration awards are binding, final and legally enforceable.

Baby steps

Sometimes smaller, more intermediate steps are needed before or during more intensive ADR methods such as arbitration or mediation. The following methods can provide information and help lessen much of the anger and suspicion that are natural by-products of construction disputes:

Fact finding. This is a neutral third-party investigation of a dispute resulting in a written report and, usually, a recommended settlement. The report can facilitate further negotiations between the parties or perhaps bring about a previously overlooked resolution.

Conciliation. Here, a conciliator brings the disputing parties together to de-escalate heated disagreements. His or her role is to reduce the parties' inflammatory rhetoric and tension, open channels of communication, and promote continued negotiations.

Mini-trial. This is a confidential, nonbinding information exchange between disputants. The mini-trial seeks to encourage prompt, cost-effective resolution of complex litigation by narrowing areas of contention, disposing of collateral issues and encouraging an equitable settlement.

Mediation/arbitration. Sometimes a neutral third party is selected as a mediator/arbitrator. Mediation/arbitration uses voluntary mediating techniques such as persuasion and discussion to reach a mutually acceptable agreement. But a mediator/arbitrator also has the authority to issue a final and binding decision when necessary.

Settle if you can

Sometimes, no matter how hard you try, you can't avoid going to court to settle a dispute. (For a detailed look at litigation, see "When all else fails" on page 4.) Although you have the right to appeal that decision, the entire process is usually lengthy and expensive. That's why, if possible, try to settle disputes without resorting to litigation. For more information on ADR methods — especially arbitration and mediation — visit adr.org. ■

Get a handle on multistate sales and use tax issues

Over the last few years, the recession has caused many construction companies to step out of their comfort zones just to stay competitive. For some, this means taking on larger projects or new types of work. For others, it means expanding into other states or even exploring international options.

If you do business in several states, it's critical to understand how each state's sales and use tax laws will affect your business. Please note: Multistate tax issues are complex — particularly in the construction industry — so a detailed explanation is well beyond the scope of this article. Our intention here is to help illustrate the importance of examining these issues *before* you bid on an out-of-state project.

Know your costs

As you know, accurate estimates are essential to a contractor's success. One mistake can make the difference between a profitable job and a loser. Before you take on work in another state,

it's important to understand how that state's tax laws differ from those in your home state.

Getting a handle on multistate tax issues will help you avoid underestimating your tax costs on a job. It may also help you identify opportunities to reduce your tax bill.

Avoid the traps

Sales and use tax laws and regulations can vary widely from state to state, and these differences can create traps for the unwary. In most states, contractors are treated as the ultimate consumers of building materials that are incorporated into a construction project. This means that the contractor pays sales or use tax on its materials purchases and treats those taxes as a cost of doing business that's passed on to the customer.

In a handful of states, however, construction services are subject to sales tax. In those states, the contractor collects sales tax from its customer on the gross proceeds under the contract. Because the customer is treated as the ultimate consumer in these states, the contractor's materials purchases are tax-exempt.

Many states also require contractors to collect sales tax from their customers under "retail sale plus installation" contracts. These are contracts under which materials are separately described, itemized and priced. The customer receives title to materials (and assumes the risk of loss) when they're delivered to the job site.

Understand the differences

States also differ in their treatment of contracts with tax-exempt entities. All sales to the U.S. government are tax-exempt, while many states also exempt sales to certain state and local government agencies and certain not-for-profit organizations.

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In some states, provided certain requirements are met, a contractor that purchases materials for a contract with a tax-exempt entity can take advantage of the customer's exemption and avoid sales and use taxes altogether. In others, materials are tax-exempt only if the entity purchases them directly. In those states, you may be able to avoid taxes by having your customer supply the materials rather than purchasing them yourself.

Plan carefully

If you're expanding the geographical reach of your business to other states, plan carefully to ensure that you estimate your costs accurately. Only by familiarizing yourself with the tax laws in these states can you determine whether you'll need to collect sales and use taxes from your customer, pay the tax yourself and incorporate the cost into your bid, or take steps to qualify for an exemption.

As mentioned above, this article is meant to provide just a few examples of the risks and opportunities associated with multistate sales and use taxes. Your tax advisor can help you deal with the many complexities involved, as well as provide assistance with multistate issues associated with other taxes, such as income and franchise taxes. ■

Use these simple tools to combat check fraud

If yours is like most construction companies today, your profit margins are thinner than usual. To protect the bottom line, it's critical to implement solid internal controls to minimize fraud, error and waste.

Fraud is a serious problem in the construction industry. In the 2010 *Report to the Nations on Occupational Fraud and Abuse*, a survey conducted by the Association of Certified Fraud Examiners, construction ranked ninth among all industries in terms of both frequency of fraud and median loss ($200,000).

One of the most common schemes today is also one of the simplest: check fraud. It's relatively easy to create a forged or counterfeit check with nothing more than a computer, scanner and printer. Fortunately, there are simple solutions to this problem.

Positive pay

Positive pay is one of the most straightforward — and effective — safeguards against check fraud. With each check run, you transmit an electronic file to your bank with a list of check numbers, account numbers, dates and amounts. Bank personnel review checks as they come in. And, most important, they won't pay a check that doesn't match the list without your approval.

For added protection, many banks allow you to set up special rules. For example, you might reserve the right to approve checks that exceed a certain amount or have been outstanding for a specified period of time.

If you don't have time to put together a list of checks each month, find out whether your bank offers "reverse positive pay." Under this approach, the bank sends you information about checks as they come in, and you approve payments on a check-by-check basis.

Going paperless

Another way to minimize check fraud is to reduce your reliance on paper checks. Many construction companies use direct deposits for payroll. If you have employees who are "unbanked" — that is, they have no bank account — you might consider using "payroll cards." Employees can use these cards to withdraw cash from ATMs or, in some cases, as a debit card.

Eliminating paper checks not only reduces opportunities for check fraud, but also decreases your administrative costs. To prevent unauthorized payments, use separate bank accounts for electronic and paper-based payments.

Be proactive

The best strategy for combating fraud is to be proactive. In some cases, your bank may ultimately be liable for unauthorized payments. But a better idea is to work with your bank to prevent check fraud from draining your account in the first place. ■