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When the Foundation Cracks: How Contractor Bankruptcies Disrupt Construction Projects

In the complex world of construction, where projects often depend on a delicate chain of contractors, subcontractors, and suppliers, financial stability is not just important—it is foundational. The moment one link in the chain falters, especially through a contractor's bankruptcy, the entire structure can be thrown into disarray. With its sweeping automatic stay and priority rules, bankruptcy can abruptly halt projects, freeze payments, and upend longstanding agreements. For owners, this poses immediate threats to project completion and cost certainty. For subcontractors and suppliers, it raises urgent questions about lien rights, payment recovery, and the status of ongoing work. This article explores the legal and financial ripples that flow from a contractor's insolvency, tracing how bankruptcy can disrupt not just balance sheets and agreements but also the physical progress of construction itself.

Bankruptcy basics in the construction context

When a project owner, developer, or upstream contractor files for bankruptcy, creditor parties often find themselves in the role of unsecured creditor—unless it asserts a lien—facing delayed payments, contract uncertainty, and potential write-offs. Chapter 7 bankruptcies cover liquidation: the debtor's assets are sold by a trustee, and contracts may recover only pennies on the dollar, if anything, after secured and priority claims are satisfied. Chapter 11, on the other hand, is often utilized in a reorganization process that allows the debtor to continue operating while restructuring its debts. For contractor creditors, Chapter 11 presents both risk and opportunity. While payments may be delayed and contract rights impaired, there also may be a chance to negotiate cure payments, preserve ongoing work, and influence plan terms through

committee participation or objection. Understanding the type of filing is critical to assessing recovery prospects and protecting lien and contract rights.

Automatic stay halting progress

The moment a bankruptcy petition is filed, the automatic stay under 11 U.S.C. § 362 springs into effect. This powerful injunction halts nearly all collection efforts, lawsuits, lien enforcement, and contract termination actions against the debtor. For construction creditors, this means that unpaid invoices, lien filings, and breach claims are frozen unless relief from stay is granted. The stay provides breathing room for the debtor to assess its obligations and propose a path forward, but it also disrupts project timelines and payment flows. Creditors must act strategically—filing proofs of claim, seeking stay relief where appropriate, and monitoring the debtor’s treatment of executory contracts—to protect their interests in the bankruptcy process.

Lien rights and priorities under threat

Mechanic’s liens are a vital tool for protecting the rights of those who provide labor or materials on construction projects. But their effectiveness depends on strict adherence to filing deadlines and procedural rules, which vary widely across jurisdictions. When bankruptcy intervenes, navigating lien rights becomes even more complicated. The automatic stay triggered by a bankruptcy filing under 11 U.S.C. § 362(a) halts most creditor actions, including the creation, perfection, or enforcement of liens against the debtor or their property. This can leave contractors and suppliers in limbo, unsure how to protect their interests. Fortunately, there are exceptions—11 U.S.C. § 362(b)(3) allows certain post-petition lien perfection if state law permits it and if the creditor’s rights are preserved under section 11 U.S.C. § 546(b). Specifically, section 546(b)(1) authorizes post-petition perfection of a pre-petition lien when state law allows that perfection to relate back to the lien’s original effective date, thereby maintaining priority over intervening claims. In high-stakes bankruptcy proceedings, this distinction can mean the difference between getting paid and walking away empty-handed. Understanding how to preserve lien rights within these legal constraints is critical.

Clawback risks and defenses

In construction-related bankruptcies, subcontractors and suppliers face significant clawback risks primarily through preference actions and fraudulent transfer claims. These actions can be especially frustrating—and often seem unjust—because they permit a bankruptcy trustee or debtor to recover payments made for valuable labor, services, or materials already provided. A “preference payment” or “fraudulent transfer action” is any payment a debtor makes to a creditor within 90 days before filing for bankruptcy (extended to one year for insiders, such as affiliates), potentially giving that creditor more than others would receive in a Chapter 7 liquidation. Even if a subcontractor completed work and was owed payment, the bankruptcy trustee can demand repayment of those funds. These

provisions serve three key purposes: deterring fraud by reversing suspect transfers, promoting equitable treatment of creditors, and preserving assets for the bankruptcy estate.

Defending against a clawback claim in bankruptcy requires a thorough understanding of both the relevant law and the specific facts of the case. Several key defenses are available, depending on the nature of the transfer. The contemporaneous exchange for value defense applies when a transfer was intended and made as a substantially contemporaneous exchange for new value, such as goods delivered for immediate payment. Creditors may also invoke the subsequent new value defense, which allows them to offset the amount of an alleged preferential transfer by the value of new, unpaid goods or services provided to the debtor after the initial payment. The ordinary course of business defense protects transfers made in the regular course of dealings between the parties or in accordance with industry standards. Additionally, the good faith defense may apply if the transferee received the transfer in good faith and provided value in exchange, particularly in the context of fraudulent transfer claims. Creditors can also rely on the statute of limitations if the trustee fails to bring a clawback action within the required timeframe. Finally, a creditor may defeat a clawback claim by challenging the essential elements of the trustee's case, such as disputing the debtor's insolvency or intent to defraud. Given the complexity and power of clawback actions in bankruptcy, a strategic defense demands meticulous attention to detail and a solid grasp of both state law and the U.S. Bankruptcy Code.

Conclusion

Bankruptcy in the construction context is never just a financial event—it's a legal shockwave that reverberates through contracts, payment chains, project schedules, and lien rights. Whether you're an owner facing stalled progress, a subcontractor chasing unpaid invoices, or a supplier defending against clawback claims, understanding the mechanics of bankruptcy law is essential to protecting your interests. From the automatic stay to lien preservation, from plan confirmation to preference defenses, each stage of the process presents both risk and opportunity. The key is to act quickly, strategically, and with a clear grasp of your rights under both state law and the Bankruptcy Code. With the right legal guidance and proactive approach, construction stakeholders can mitigate disruption, preserve claims, and position themselves for recovery—even in the face of insolvency.

Contact us

If you have any questions about bankruptcy in the construction context, please contact Tara LeDay, Maya Dokic, or your Husch Blackwell attorney.