

MDC ADVISOR

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When faced with a construction default, sureties often engage consultants to perform investigations to ascertain the most prudent response. This article examines the crucial aspects of the investigation.

Construction Defaults: The Need For Expert Advice

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A construction project in default is an emotionally charged situation, with many parties exposed and a lot of money at risk. The owner's use of the facility will be delayed. The contractor's work on the project and perhaps years in business may come to an end. The designer's envisioned project is on hold. The surety faces an uncertain exposure.

Of these parties, the surety has the most pressing need to be brought up to speed on the project, as it is usually not as intimately involved as the owner, contractor and designer. These other parties may be so wrapped up in the project financially and emotionally, that the surety cannot rely upon their perceptions and advice in assessing the surety's proper course of action. Thus sureties often retain consultants to investigate the project, finances, performance, status of the work, and recovery. Likewise, the owner may retain a consultant to watch out for the owner's interests.



Protecting Surety Rights

The consultant retained by the surety must be ever vigilant not to jeopardize the surety's rights to the contract balance and its right to be indemnified by the contractor/principal. In addition, the consultant must ascertain whether the contractor is truly in default; if not, the surety has no liability under the bond to the owner/obligee. The surety's consultant may conduct an exhaustive investigation geared to recognize problem areas, to analyze critical technical and cost matters, and to present a comprehensive report providing sound conclusions and recommendations. The investigation must be done quickly to enable the surety to make crucial decisions to avoid enormous dollar losses which could result from delays.

Required Investigation

Four areas of inquiry are often

undertaken by surety consultants: (1) the financial condition of the contractor/principal; (2) the ability of the contractor to complete the work; (3) the financial status of the project; and (4) the physical status of the work. Each of these aspects must be judiciously investigated to ascertain how the surety can most prudently meet its performance obligations, and whether any substantial defenses exist.

Contractor Finances

A fundamental concern is the financial condition of the contractor, whether its finances are adequate to allow it to meet its primary obligation to perform. Often strange things lurk beneath the surface of balance sheets and financial reports provided by contractors. It is prudent to dig into stated liabilities, such as loans, taxes, fringe benefits, invoices, unpaid

subcontractors and suppliers, and administrative operation costs relating directly to the bonded project. In addition, there are relevant liabilities not covered directly by the bond, such as other outstanding creditor claims, litigation, and costs relating to other bonded or unbonded projects. Stated assets often have less value than purported and may not be liquidated easily. It is not uncommon that contract funds from the bonded project often disappear into a black hole.

Ability to Complete

The resources necessary to complete the bonded project often go beyond numbers on a financial report. Management talent at all levels and responsibilities may disappear in troubled times. Even qualified managers may be hampered by lack of experience in the geographic area or type of work involved in the bonded project. Other pitfalls include soured relationships with the owner or project architect, unavailable trade labor force, inadequate tools and equipment, incompetent subcontractors, troubled suppliers, bungled purchase orders, and rumors of financial problems that may cut off vital relationships.

Project Finances

Often the financial status of the bonded project makes the contractor's performance infeasible. Overpayment can be as devastating as underpayment, and may provide the surety with a defense to the surety's performance obligation. Many contractors struggle waiting for payments for change orders performed months earlier. It is imperative to determine the status of all change orders—approved, pending, rejected, in progress or completed without formal approval.

Inappropriate back charges, improperly assessed liquidated damages and meritorious but unpaid claims may also provide additional contract funds. However, such funds may be readily depleted by unpaid suppliers, subcontractors, creditors, liens or judgments. Further, defective work is a dangerous unknown that may jeopardize the project's financial outcome, especially as latent defects may not appear for months.

Perhaps the most crucial aspect of the investigation is the determination of the cost to complete. The approved payment requisitions may not properly reflect the percentage of work completed. The bonded contractor will likely provide an optimistic cost to complete that must be tempered with an independent estimate by the consultant or even a potential completion contractor. Determining the cost to complete is a challenging endeavor, often qualitatively different than cost estimating undertaken prior to construction or in support of change orders. For example, the cost to complete could increase significantly if different trade contractors are required to mobilize or if substantial remedial work is required. Such contingencies may be difficult to price.

Job Status

The fourth aspect of the investigation is the physical status of the work, as the consultant must inspect the project to determine the extent and quality of work in place. Ascertaining installed quantities may be difficult because some work items are not easily counted. The quality of the work is even more controversial, as the level of acceptability is often in the eye of the beholder. Judgment is required to determine whether work is in accordance with plans, specifications, and generally accepted practices. Estimates of remedial costs will also vary. In addition, the amount, condition and value of stored material must be assessed.

Also, important in assessing the physical status is an understanding of the contract time, actual performance

to date and an objective evaluation of the time required to complete the work. Scheduling expertise will come to bear in determining a realistic completion schedule, entitlement to time extensions, assessment of liquidated damages and delay claims.

The Performance Decision

The ultimate purpose of the consultant's investigation is to provide insight, accurate information, and practical recommendations to the surety in a timely manner so that it may make prudent decisions concerning its performance obligations. As discussed in the *Primer* article on page 3, there are several options that the surety may consider in responding to the default of the contractor/principal. However, assessing the relative wisdom of each possible response requires reliable and expedited analysis from seasoned construction experts. ■

Announcement



Francis J. Brennan, P.E., was recently named a Vice President in MDC's Florham Park office where he will assume responsibility for construction management assignments in the Northeast, as well as continue his work in claims and surety consulting.

Credits

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CONSTRUCTION PRIMER

The Surety's Completion Alternatives for Defaulted Contracts

When faced with a default on their projects, many owners have unrealistic expectations concerning the surety's obligations under the performance bond. Owners feel frustrated when the surety does not aggressively step in to complete the work. However, under most performance bonds, if the contractor/principal is in default, the surety may discharge its obligations by any one of the following alternatives: (1) finance the contractor/principal to complete the work; (2) obtain a new contractor to complete the work under a direct contract with the owner/obligee; (3) complete the work with a new contractor under a contract with the surety; (4) permit or require the owner/obligee to obtain a new contractor; and (5) do nothing and wait for the owner to take action against the bond. As discussed in the lead article on page 1, deciding which option to exercise requires prudent management decisions often based upon reliable, accurate, and expeditious investigations by an experienced consultant.

Financing the contractor/principal to complete the project in many cases is not the most attractive option for the surety, unless the work is nearing completion. As the contractor's financial problems become known, its most capable employees will leave to obtain more secure employment, and its remaining workforce may attempt to prolong the work to preserve their jobs. Additionally, if more than one contract is in default, whether bonded or unbonded, it is impractical to finance one contract while permitting defaults on the others.

In some instances, financing the contractor may be the least costly way for the surety to meet its performance obligations. The workforce

and subcontractors may be mobilized on-site and familiar with the work. Although subcontractors are often gun-shy and disgruntled over unpaid requisitions, they are often persuaded by the promises of the surety bankrolling the job. Even though some increases and adjustments may flow to the existing subcontractors and suppliers, the surety can minimize the completion costs by bargaining with the existing team to hold as closely as possible to the previously negotiated prices.

Often owners will prefer to have the surety obtain a completion contractor but **the owner may hold** the contract with the new completion contractor, because of the perceived control and security it provides concerning the quality and timing of the project completion. Further, owners often prefer starting anew with the management of the replacement contractor rather than continuing the frustrations with the defaulted contractor. However, there are risks associated with the clean slate. The potential for unknown remedial costs could fall upon the owner once the surety has established a direct contract between the owner and the replacement contractor. Owners would be wise to clarify these risks and responsibilities with both the surety and the completing contractor. Finally, owners are often tempted to direct substantial changes on a time and material basis to the replacement contractor to deal with marginally acceptable work done by the defaulted contractor, tenant requested revisions, or other desired improvements.

The surety which **directly engages** a replacement contractor may also face substantial risks. Its exposure may not be limited to the face amount of the bond if it assumes the role of the contractor/principal in completing the work. Therefore, the completion surety will often seek a formal **takeover agreement** with the owner to limit its exposure, to deal with specific issues, and to facilitate cooperation with the owner and its architect/engineer. Further, the surety's agreement with the replacement contractor should incorporate existing subcontracts and equipment purchase orders, after making payments for work performed and deliveries made. If the surety has

provided both payment and performance bonds, continuing the subcontracts and purchase orders may minimize claims made against the payment bond, as well as minimize the cost to complete obligation under the performance bond.

Where cooperation between the owner, its architect/engineer, and the surety cannot be assured, the surety may permit or require **the owner to procure** its own completion contractor. Although the surety is often better able to locate completion contractors, some owners may have potential candidates immediately available. Further, owners may perceive the surety as an obstacle to securing timely project completion, and with the permission of the surety, the owner will engage the completion contractor with minimal involvement by the surety. In such instances, the surety is liable for the cost of completion in excess of the contract balance held by the owner. In this case, the surety's exposure is limited to the **face amount of the bond**, however, the surety must assure itself that the owner's completion costs are not escalated by scope changes and substantial improvements. In order to recoup the excess costs, above the original contract amount, the owner must be careful in reprocurring the work.

In some circumstances, the surety may feel justified in **doing nothing** in response to the owner's declaration of default. For example, the surety may allege that:

- the principal is not truly in default;
- the principal is not insolvent;
- the owner has retained ample funds to pay for completion; or
- there has been a gross departure from the terms of the contract.

The surety tempted to **do nothing** in response to a declaration of default faces unknown costs associated with a lack of control or direction for the project completion. For example, unauthorized changes, improvements, and added costs will generally accompany the completion of a defaulted project, greatly increasing the completion costs and the potential for litigation.

By communication and involvement in the takeover, the surety can minimize its costs and the potential for costly litigation often associated with defaults. ■

CASENOTE

Default Termination: Cancelled Insurance

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Although any violation of the terms of a construction contract may be considered a breach, under most construction contracts and applicable caselaw only **material breaches** will justify termination of the contract for default. For example, many construction contracts delineate specific reasons for default termination, such as persistent failure to supply adequate

skilled workers or failure to pay subcontractors and suppliers, and also make provision for termination for other "substantial" breaches of the contract. However, parties involved in construction disputes are often confused as to whether certain violations are serious enough to justify default termination.

The parties to a sub-subcontract faced this issue in *Tyro Industries, Inc. v. Trevoze Construction Co., Inc.*, 737 F. Supp. 856 (E.D. Pa. 1990). Tyro, the sub-subcontractor, allowed its contractually required general liability insurance to lapse because of nonpayment. The owner's representative notified the subcontractor (Trevoze) that because of the cancellation of Tyro's insurance, Tyro would no longer be permitted to work on the project. After confirming through several sources that the policy was cancelled, Trevoze terminated Tyro's sub-subcontract. Tyro sued Trevoze for improperly terminating the sub-subcontract.

The federal district court granted Trevoze's motion for summary judgment after examining various issues. One key issue was the determination of whether the failure to maintain the required insurance constituted a material breach, justifying the default termination. The court recognized the critical role that insurance plays in managing the risks inherent on construction projects, and that carrying the specified insurance was a condition precedent to this contract. Noting other cases where the failure to **procure** liability insurance was deemed to be a material breach, the court reasoned that failure to **maintain** the required insurance also justifies termination for default. ■

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