

CONSTRUCTION PROJECTS IN DEFAULT

THE CONTRACTOR'S PERSPECTIVE

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While I expect that the hypothetical will engender spirited discussion, before even attempting to provide advice to Killefer, the general contractor, it would seem to me that an attorney should make an effort to determine the following facts.

1. Contractor/Subcontractor Contractual Relationship.

On the West Coast, where most of my practice is concentrated, it is uncommon, in larger projects, for the developer to enter into direct contractual relationships with subcontractors and/or material suppliers; the most prevalent form of project delivery is a chain running from the Owner to General Contractor to subcontractors/suppliers. Even for projects where the subcontract packages (mechanical, electrical, plumbing, finish carpentry) may be "pre-bid" by the Owner, the bidding packages generally call for the assignment of the subcontracts to the general contractor as soon as one has been selected and the final price or guaranteed maximum has been settled on.

It is my understanding that the situation is somewhat different in the East, i.e. in many cases (some required by law) the Owner enters into direct contracts with the traditional sub-trades, with a wide variety of coordination and administrative functions being up to the General Contractor. In the case posited in the hypothetical, it is unclear as to the exact nature of the contractor/subcontractor relationship, but it is critical to the General Contractor's immediate problem, i.e. is it the General who is being pushed by the subcontractors/suppliers for payment or is it the Developer.

Ultimately, in a project where there exists a direct contractual relationship between the general contractor and the subcontractor, even with a carefully crafted "pay when paid" provision in the general contractor/subcontractor document, the general is going to be financially responsible either in a direct contract action by the subcontractor/supplier or by virtue of indemnification to the owner for lien rights asserted by the subcontractor and/or supplier in the event of non-payment.

2. Progress Payment Applications

A review of all of the progress payment applications should be made in order to determine their status as against the agreed Schedule of Values or similar cost or budget breakdown. A comparison should then be made between the amounts paid toward budgeted work as to scheduled work. Assuming the Contractor has kept accurate records of changed vs. original contract work, a determination should be made of the following: Actual Cost of Work Scheduled (ACWS) vs. Budgeted Cost of Work Scheduled (BCWS) and Actual Cost of Work Performed (ACWP) vs. Budgeted Cost of Work Performed (BCWP). Once again, assuming a sufficiently detailed Schedule of Values or budget, this information should help develop a picture of those elements of the project that are having particular problems or are suffering delays. This information will be essential in determining two key financial numbers everyone is going to be

interested in knowing: the present Estimate at Complete (EAC) and the Estimate to Complete (ETC).

3. Lien Status

In connection with the review of the Progress Payment Applications, a thorough review should be made of the contract documents and pay applications with regard to the nature, extent and precise language of any lien waivers executed by the general contractor and/or subcontractors and suppliers in connection with the receipt of progress payments.

4. Contract Modifications or Change Orders.

Any contract modifications or change orders should be reviewed for language of waiver or release. The following release language in a Contract Modification or Change Order has been held to be an effective waiver:

The Contractor agrees to release and discharge the Owner and Architect from all claims or demands for price increases, time extensions or other claims for benefits of whatever kind or character arising on or before the date of this modification that the Contractor had or may have by virtue of changes and/or suspensions of work, constructive or otherwise, and from any and all other claims arising under or in connection with this contract on or before the date of this modification.

5. Contract Clauses relative to Disputes, Changes and/or Suspensions of Work

The typical construction contract (particularly if modeled after a government contract or AIA form) will contain clauses relating to resolution of disputes, compensation for changes and suspensions of work. With respect to the Changes Clause particular attention should be paid to the provisions for notice, exception and presentation of any claim for additional compensation. The Disputes Clause will cover the particular procedures required if the parties to the contract cannot agree on an element of the work or any claim for additional time or compensation. Most importantly, the disputes clause will generally require the contractor to keep working pending resolution of any dispute. The following language is typical:

There shall be no interruption in the prosecution of the work, and the Contractor shall proceed diligently with the performance of this contract pending final resolution of any dispute, claim, or litigation arising under or related to this contract.

Absent extraordinary circumstances (e.g. financial hardship amounting to commercial impracticability) the requirement to continue to work pending resolution of a dispute is enforceable and a failure to continue will constitute a breach.

If the work is delayed or has been delayed by virtue of missing or improper design information, which the owner is responsible to provide, the contractor may be able to claim that the work has been constructively suspended. However, suspension clauses typically contain relatively short notice requirements which will bar any payment for additional costs which arise X number of days before the notice. One or more

meetings with on-site project personnel who would have knowledge of delayed or suspended work (and the reasons therefore) should be promptly held.

6. Contract provisions regarding Payment.

The typical construction contract will permit the contractor to stop work upon non-payment after a certain number of days. Once again, strict compliance with the notice procedures in the contract must be followed in order to be able to invoke the rights provided.

7. Contract Provisions regarding Termination

Generally, there will be at least two clauses dealing with termination: default and convenience. The exact language of both provisions should be carefully reviewed.

It is not atypical to find language in the default provision that permits the owner to take over the contractor's "plant and equipment present on site" in order to complete the work. In a situation such as that described in the hypothetical, one of the first things to be done would be to determine what equipment may be demobilized or otherwise removed from the site on relatively short notice. Consideration should be given to obtaining a staging area close to the construction site to which large items of equipment (cranes, generators, light plants, compressors) may be taken while the parties are in negotiations. However, care should be taken so as to avoid being accused of "abandoning" the work.

A termination for convenience is a right generally reserved to the owner. If the contract is terminated for the convenience of the owner, the contractor is generally entitled to be paid its costs through the date of termination, together with profit on those costs. Be careful, in that most, if not all, termination for convenience clauses contain provisions for "loss adjustment" i.e., if it can be shown that the contractor would have suffered a loss on the contract, its recovery is limited to the same ratio of loss that it would have suffered had the project been completed.

8. Performance Bond and Indemnity Agreement

Read and study the precise language of both the performance bond and the indemnity agreement between the contractor (and its principals) and the surety. Have all the necessary formalities for enforceability been met? In the indemnity agreement, is there a choice of law or disputes (i.e. arbitration) provision? If an action is brought under the indemnity provision, is there a clause concerning non-joinder? What collateral is the surety entitled to prior to determination of liability?

9. Forum Selection

What provisions, if any, in the Owner/Contractor agreement govern forum selection, involuntary joinder of parties (e.g. American Institute of Architect forms), choice of law? Is there a potential conflict between a choice of law provision in the contract and the situs of the work? Which law will govern in the event of such a conflict, for example the law applicable to timeliness and notice with respect to liens?

10. Schedule status as it relates to future construction activities

Often overlooked while everyone is concerned about the project finances, is the status of construction vis-à-vis the weather and future scheduled activities. Are there upcoming activities that can be severely delayed due to the impact of the failure to complete prior activities? For example, the author had experience with a project that was delayed for over 6 months because the building skin was delayed by about 6 weeks. As a result of the failure to obtain closure, mechanical, electrical, HVAC work was devastated when the work was trying to be performed in a building exposed to the weather on the shore of Puget Sound during the winter. In the case of the hypothetical, will current delays push work (final site paving or landscaping) into unfavorable weather?

11. Financial resources

A subject that is often times difficult to bring up, particularly with a new client, but one that is extremely important in a situation such as that posed in the hypothetical. Possible courses of action may be constrained by the Contractor's ability to fund cost overruns or to provide necessary assurances of the ability to indemnify the surety.