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CONSTRUCTION LAW

Cooperative Surety Can Help Salvage a Defaulted Project

By **Kenneth M. Block** And **John-Patrick Curran**

Picture this scenario: You are the owner/developer of a residential condominium project which is approximately 50 percent complete and you are operating under a tight time schedule to complete the project and close on several unit purchase agreements. Your general contractor informs you that, due to economic distress, the last requisition funded by your lender was used to pay subcontractors on a different project. You also are informed that the general contractor plans to close its business and that several subcontractors are preparing to file liens. The project is grinding to a halt.

A substantially similar scenario recently faced a client of ours and, working with the general contractor's payment and performance bonds surety, we succeeded in resurrecting the project and placing it on a sound path to completion. We believe our experience provides a helpful guide to the practical operation of payment and performance bonds in the context of an undisputed contractor default.

The Performance Bond

Under the terms of the most commonly used form of performance bond (AIA Document A312-1984) the surety is, in effect, the guarantor of the contractor's performance, conditioned only upon the owner's fulfillment of its payment obligation under the construction contract. The trigger for the surety's obligation is a default by the contractor. However, prior to the declaration of a contractor default, the owner must comply with provisions of the performance bond requiring the owner to notify the surety and the contractor that it is considering declaring a "Contractor Default" and to request a conference with the contractor and the surety "to discuss methods of performing the Construction Contract" (AIA Document A312, paragraph 3.1).

This so-called 3.1 conference must be held not later than 15 days after the receipt of the owner's notice by the contractor and surety. Regardless of the outcome of the conference, the owner may thereafter declare a default, but no earlier than 20 days after the request for the 3.1 conference has been given. The owner must also agree to pay the balance of the contract price to the surety in the event a contractor default is declared.

Four Options

If the surety is satisfied that a contractor default exists and is prepared to assume responsibility for the completion of the construction contract, it has four options under the bond: (1) arrange for the contractor, with the consent of the owner, to complete the construction contract; (2) undertake to perform and complete the construction contract through its agents or independent contractors; (3) obtain bids or negotiated proposals from contractors acceptable to the owner for new contracts to complete the project and pay to the owner damages incurred as a result of the contractor default in excess of the balance of the contract price; or (4) determine the total amount for which it may be liable to the owner and tender payment thereof in full satisfaction of its obligations. (Generally speaking, the surety will select one of the foregoing options only where the contractor's default is undisputed. In the absence of an undisputed default, the surety will invariably side with the contractor and deny liability under the bond, leaving the owner with two defendants—albeit with one presumably possessing assets—should litigation ensue.)

Returning to our scenario, promptly after the owner learned of the contractor's misapplication of the loan proceeds (a diversion of trust funds), it notified the surety and contractor that the owner intended to declare a contractor default and requested a 3.1 conference. At the conference, the surety, accompanied by an outside claims consultant (but without the contractor, which by then was functionally bankrupt) met with the owner to discuss the circumstances of the contractor's default and to consider which of the four options under paragraph 4 of the performance bond would be most appropriate.

Given the concession by the contractor that monies were diverted and that it had discontinued operations, the surety authorized the owner to begin a search for a replacement contractor. The surety also agreed to arrange for its consultant to contact each subcontractor to determine amounts due and owing as well as balances to complete the work. Further, the surety requested access to the site for the purposes of determining the quality and progress of construction to assist it in making a determination as to which of the remaining options under paragraph 4 of the bond it would follow.

The 3.1 conference then concluded with an agreement that the contractor would be formally terminated and that a replacement contractor would be retained to complete the project. Whether the new construction contract would be with the surety, with the owner or a tender payment would be made by the surety was left open for further discussion.

KENNETH M. BLOCK *and* JOHN-PATRICK CURRAN *are partners of Tannenbaum Helpern Syracuse & Hirschtritt.*

Subcontractor Negotiations

A determination had also been made at the 3.1 conference that it would be most economical to complete the project utilizing substantially all of the existing subcontractors, and the surety undertook to negotiate ratification agreements with each subcontractor. The ratification agreements would recite the original subcontractor amounts, the approved change orders, the value of work completed as of the termination of the general contractor, the amount of retainage, the amount due, and the remaining contract balance.

By reason of the payment bond, the surety would also agree to pay the subcontractors the amounts currently due (which had been diverted by the contractor). For their part, the subcontractors would ratify their existing subcontracts and agree to honor all guaranties and warranties and to be bound to the surety or a successor contractor to complete the subcontract work. Where agreements could not be reached with subcontractors and disputes as to amounts due led to the filing of liens the surety undertook to discharge those liens through bonding.

New Contractor

The challenge facing the owner and the surety was determining a fixed price for the completion of construction. The owner required a fixed price to satisfy its lender that the project could be completed within the construction loan amount and the surety required a fixed price to determine its ultimate exposure under the performance bond.

A construction manager was then mutually selected by the owner and surety to secure the site and investigate existing conditions, with compensation on the basis of a monthly fee. At first, the construction manager was only willing to complete the project as an agent of the owner without risk, contending that it did not have pre-existing relationships with the subcontractors and it was concerned that latent defects might result in unknown costs.

However, because of the need for a fixed price, both the owner and surety encouraged the construction manager to engage in whatever investigation and testing was necessary to satisfy itself as to the quality of the work and the scope and cost to complete. The construction manager also interviewed each subcontractor to satisfy itself that a new working relationship could be established, and confirmed that the subcontract balances were sufficient to complete the work. The construction manager also performed a detailed scheduling analysis to determine the time to complete the project and its cost of supervisory personnel.

At the conclusion of the construction manager's due diligence, a guaranteed maximum price was established providing for a substantial contingency for the benefit of the construction manager in the event the ultimate project cost exceeded its estimate. Protections were also added to the construction management agreement relating to latent defects arising from the work of the defaulted contractor.

Finally, based on the ratification agreements, the subcontracts were assigned to the new construction manager, which took over full responsibility for the completion of the project at a fixed price acceptable to the owner, the owner's lender, and the surety.

Owner's Agreement

During the several months between the contractor's default and the conclusion of an agreement with the new construction manager, the owner engaged in continuing negotiation with the surety as to the surety's full liability under the performance bond which, in this case, had a penal sum of 50 percent of the original contract sum. (Often, in order to save premium cost, performance bonds are issued for less than the full amount of the contract sum. In our scenario it was believed that a penal sum equivalent to 50 percent of the contract sum would adequately protect the owner against a contractor default. As matters developed, that belief was accurate.)

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It quickly became apparent that the surety wished to follow the fourth option under the performance bond by tendering payment to the owner of a negotiated amount representing the surety's potential liability to the owner under the bond, which could include: (i) the costs to correct defective work and complete the construction contract; (ii) any additional legal, design professional and delay costs resulting from the contractor's default; and (iii) liquidated or actual damages caused by delayed performance or nonperformance of the contract.

Under our scenario, the cost to complete the project greatly exceeded the remaining contract balance; the owner had incurred legal, architectural, project management and engineering costs directly related to the contractor's default; and the owner anticipated incurring additional costs to carry the construction loan (including the payment of real estates taxes) until the project was completed and the condominium sales could be concluded.

After extensive negotiations, the parties reached an agreement as to the amount of the surety's tender. The tender agreement with the surety also covered the assignment of the ratification agreements, the handling of latent defects (for which the surety would remain liable), and potential claims of subcontractors with whom ratification agreements could not be reached.

Having successfully negotiated a fixed price agreement with a new construction manager and a tender agreement with the surety which allowed the owner to recoup a substantial portion of its damages resulting from the contractor's default, the owner was able to obtain approval from its construction lender and loan proceeds began to flow, facilitating the resumption of construction.

Conclusion

This scenario illustrates the steps which can be taken with a cooperative surety in salvaging a project following a contractor's undisputed default. In such a circumstance, it is in the interest of the surety to assist the owner in mitigating its damages by bringing the surety's full resources to bear and working with the subcontractors and a replacement contractor to contain the cost to complete the project. Unlike a scenario where a contractor's default is in question, acrimony and litigation was avoided with a successful outcome to both owner and surety.

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