



MANAGING CONTRACTOR DEFAULT RISK

ANATOMY OF A DEFAULT CLAIM

Presented by

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One of the most disruptive events in a construction project is a contractor's failure to perform its contractual obligations, especially completion of the agreed-upon work. Performance bonds are frequently utilized to protect the hiring party (owner or contractor) from the financial impact of a contractor or subcontractor default, including the cost of finding a replacement contractor, higher contracting costs, and delays caused by the default. However, many contractors choose to self-insure this risk, and minimize the risk of default using a rigorous prequalification process to select qualified and financially secure subcontractors. Recently, several insurers have developed an insurance policy that provides a form of stop loss coverage for contractor default. In this session, learn strategies for helping your clients make an informed decision on whether to self-insure, bond, or insure this risk. Also learn how to assist your client in minimizing the financial impact of a default no matter which method of financing is selected.

Default

Monday, November 13, 9:00 a.m.–5:00 p.m.



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Mr. Ness is one of the presenters for Monday's all-day seminar, "Managing Contractor Default Risk." He is a partner in the Washington, D.C., office of Thelen Reid & Priest LLP, where his practice focuses on dispute resolution and counseling with respect to construction- and design-related matters representing primarily owners/developers, engineers, and prime contractors. Mr. Ness has been lead counsel on a wide variety of major construction disputes in federal and state courts, and in both domestic and international arbitrations. He also has extensive experience in the use of mediation and other alternative dispute resolution techniques to resolve construction disputes. In addition, he has worked extensively in drafting and negotiation of design and construction contracts, and in resolving problems short of litigation. His projects nationally include major power plants, process plants, cogeneration projects, petrochemical facilities, hotels, regional shopping malls, office buildings, and laboratories. Internationally, he has worked on refineries (Caribbean and Eastern Europe), offshore oil platforms, pipelines and pumping stations (United Arab Emirates and Saudi Arabia), and a cement plant and port facilities (Southeast Asia).

He earned his juris doctorate degree, *magna cum laude*, from Harvard Law School, in 1977. He earned a bachelor of science degree in Electrical Engineering, with distinction, from Stanford University, in 1974. His professional qualifications, memberships, and activities include membership in the bar associations of the District of Columbia, Virginia, and California; chair of Division 10, Legislative and Environmental, American Bar Association Forum on the Construction Industry; vice chair, Construction Division, ABA Public Contract Law Section; charter member of the Advisory Board for *The Government Contractor*, a weekly publication of the West Group; and review panel member, *Journal of Construction Engineering and Management*, published by the American Society of Civil Engineers, Construction Division. He is also the author of numerous articles on construction law topics and speaks frequently on a wide range of construction law issues.

Notes

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ANATOMY OF A DEFAULT CLAIM

*Andrew D. Ness
Thelen Reid & Priest LLP*

I. Establishing Material Breach of Contract

- A. The “barely contested” default
- B. The “hotly contested” default
- C. Grounds for default
 - 1. Bankruptcy, insolvency, assignment for the general benefit of creditors
 - 2. Failure to complete the work on time
 - 3. Failure to prosecute the work in a manner to ensure completion within the specified time
 - 4. Failure to comply with contract requirements
 - 5. Persistent or repeated failure to obey laws or regulations
 - 6. Repudiation of the contract
 - 7. Other material breach

II. Notice of Default and Opportunity To Cure

- A. Multiple notice requirements
- B. Need for strict compliance
- C. What is a reasonable opportunity to cure?

III. Options Short of Full Termination

- A. Taking over tools, materials, labor
- B. Supplementation of force
- C. Supplementation of management and supervision
- D. Providing additional financing
- E. Partial termination for default

IV. Dealing with the Surety

- A. Bond notice requirements
- B. The surety’s options
 - 1. Funding the contractor’s completion
 - 2. Completion with a replacement contractor
 - 3. Reservation of rights

V. Damages for Default

- A. Determining the cost of completion
- B. Typical complexities in costs of completion accounting
- C. Determining the remaining/unpaid contract balance
- D. Administrative and management costs
- E. Attorneys fees
- F. Consequential and special damages

Notes

ANATOMY OF A DEFAULT CLAIM

Introduction

- Termination - The Ultimate Threat & Sanction
- Termination for Convenience
- Termination for Default
 - ◆ Owner Defaulting the Prime Contractor
 - ◆ Prime Contractor Defaulting a Subcontractor

The “Barely Contested” Default

- Apparently Failing Business
- Clearly Lacks Resources to Complete Contract
- Often No Bond
- Protests Default, But Weakly

The “Hotly Contested” Default

- Ongoing Business
- Vociferously Disputes Default
- Worried About Impact on Future Business
- Substantial Claims For Pre-Termination Events
- Litigation Inevitable

Material Breach -- The Keystone to a Proper Default

- Must Be Substantial Breach
- Impacts Benefit of the Bargain
- Occurs Prior to Substantial Completion
- Material Breaches Further Specified in Default Clause

Grounds for Default

- Grounds Under Article 14.2.1 of AIA Document A201
- Other Grounds Commonly Seen in Default Clauses
- Common Law Grounds

A201 Grounds for Default

- Persistently or Repeatedly Fails to Supply Enough Skilled Workers or Proper Materials
- Fails to Make Payment for Materials or Labor per Subcontract
- Persistently Disregards Laws, Regulations or Orders of a Public Authority
- Otherwise Guilty of a Substantial Breach of the Contract

Other Default Provisions

- Bankruptcy, Insolvency, or Assignment for General Benefit of Creditors
- Intentionally Falsified Statements or Invoices
- Filing of Lien Not Promptly Removed

Other Default Provisions (Cont'd)

- Failure to Meet Completion Date
- Failure to Prosecute the Work Promptly and Diligently
- Failure to Make Adequate Progress to Timely Complete

Failure To Make Adequate Progress

- Just Being Behind Schedule Does Not Justify Default
- Must Show That Completion Date Cannot Reasonably Be Met
- Will Need to Rebut Claims of Excusable Delays

Other Default Grounds

- Failure to Meet an Express Condition Precedent to Performance
- Abandonment
- Anticipatory Repudiation
 - ◆ Express
 - ◆ Implied
- Failure to Provide Adequate Assurances

Express Anticipatory Repudiation

- Express Representation
- Intent Not to Perform Communicated in a Positive and Unequivocal Manner
- Definite, Unequivocal Refusal to Perform Work Under the Contract

Implied Anticipatory Repudiation

- Premised on the Implications of a Party's Actions
- Party's Acts Unequivocally Manifest An Intention Not to Perform

Failure to Provide Adequate Assurances

- Concept Derived from UCC
- Right Arises When Other Party Feels Insecure Due to 1st Party's Actions
- Failure to Provide Adequate Assurances May be Anticipatory Repudiation
- What Are Adequate Assurances?

Notice of Default (per A201)

- Certification of Architect
- 7 Day Notice of Intent to Terminate
- Notice to Surety
- Older Versions of A201 Require Two Separate Notice Steps

Notice/Opportunity to Cure

- Primary Purpose of Notice is Opportunity to Cure
- Need for Strict Compliance With Notice Requirements
- What is a Reasonable Opportunity to Cure?

What Is Reasonable Opportunity to Cure?

- Complete Correction of the Problem?
- A Recovery Plan?
- A Promise to Provide a Recovery Plan?
- What If the Problem is Inherently Uncorrectable?

Options Short of Default

A201 - Article 2.4.1 - Owner's Right to Carry Out the Work

- Where Contractor "Defaults or Neglects to Carry Out the Work"
- Requires Two Notices (7 days and 3 days)
- Need to Commence and Continue Correction Within Notice Periods
- Gives Owner Right to Correct and Deduct Cost

Other Possible Options

- Reduction of Scope
- Taking Over Tools, Materials and Labor
- Supplementation of Force or Management
- Providing Additional Financing
- Partial Termination for Default

Owner Rights Upon Default (A201)

- Take Possession of the Site
- Take Possession of Materials, Equipment & Tools
- Accept Assignment of Subcontracts
- Finish the Work by Reasonable Method Deemed Expedient
- Make No More Payments Until Work is Done

Dealing With the Surety

- Bond Notice Requirements
- The Surety's Options:
 - ◆ Funding Completion by Contractor
 - ◆ Funding Completion by Owner
 - ◆ Completion by Surety's Contractor
 - ◆ Tender New Contractor to Owner
 - ◆ Reservation of Rights

Damages for Default

Basic Measure (per A201) is:

- Cost of Finishing the Work, including
 - ◆ Architect's Services and Expenses
 - ◆ Other Damages Incurred by Owner
- Less Unpaid Balance of Contract Sum
- Furnish Contractor Detailed Accounting of Cost to Finish

Additional Types of Damages

- Owner Administrative and Management Costs
- Attorneys Fees
- Consequential and Special Damages
 - ◆ Loss of Use
 - ◆ Additional Construction Loan Interest
- Actual Delay Damages

Determining the Unpaid Contract Balance

- Contract Balance Not Requisitioned
- Amounts Requisitioned But Rejected
- Payments Earned But Not Made
- Change Order Work:
 - ◆ Completed
 - ◆ Partially Completed
 - ◆ T&M Work Done But Not Billed

Determining the Costs of Completion

- Use of Cost-Reimbursable Completion Contractors
- The Need to Stay “Scope to Scope”
- Accounting For Post-Termination Changes
- Potential For a Cost Accounting Nightmare