

Workshop I

Wednesday, November 9, 9 a.m.–noon

MANAGING THE COMPLETION/ TAKEOVER PROCESS FROM THE OWNER'S AND SURETY'S POINTS OF VIEW

Presented by

James V. Farrell
Senior Managing Director
FTI

Douglas L. Patin
Attorney
Bradley, Arant, Rose & White

Construction bonds provide assurance that a contractor or subcontractor will fulfill their obligations under the construction contract. Unfortunately, the protected party often has no idea what to expect when making a claim against the bond and is not prepared to navigate these unfamiliar waters. This session will address the surety response to performance and payment bond claims. The first half of the session provides an overview of the surety's obligations to involved parties as well as its investigation and defense of performance and payment bond claims. The second half of the program focuses on the actual completion process, including evaluating the completion options, selecting a remedy, negotiating takeover agreements, dealing with subcontractors, and the impact of bankruptcy on a bond claim. Attendees will leave this very practical session with a greater understanding of the factors that must be considered in handling a bond claim as well as how to manage the completion process.



WE LIVE SERVICE![®]

in Insurance, Risk Management and Surety

service: (səɪ-vəs)

- n.** 1. dedication to a task, timely; see **READY / WILLING / HELPFUL**. 2. the act of being devoted to helping others.
- v.** 1. to meet the needs of.

Lockton has been expertly **servicing** construction accounts for over four decades. Our experienced Associates are the most sought-after insurance professionals in the industry, and our groundbreaking, 360-degree approach to client needs will ensure that you are covered from all angles. No one builds quality client relationships and programs like Lockton.

Dedicated. Devoted. Dynamic.

Lockton, the construction insurance expert.



LOCKTON[®]

Atlanta Chicago Dallas Denver Hartford Houston Irvine Kansas City
Las Vegas Los Angeles New York San Diego San Francisco St. Louis Washington, D.C.

James V. Farrell
Senior Managing Director
FTI

Mr. Farrell is a copresenter for Workshop I, "Contractor Default Claims," on Wednesday morning. He is a senior managing director in the FTI Forensic and Litigation Consulting practice and is based in Chicago. Mr. Farrell has over 20 years' experience in providing expert witness testimony and consulting advice in cases involving construction accounting and auditing, government contracting, environmental claims, and complex construction claims. He has testified as well as interacted with other testifying experts involving breaches of contract, acceleration, delay, disruption, termination, cost accounting, cost overruns, government accounting, home and field office overhead, Eichleay calculations, business interruption, and lost profits. In addition, as the general manager and principal accounting officer for a real estate development and construction conglomerate, Mr. Farrell was responsible for the preparation of all internal and external financial information, establishment and implementation of cost control systems, and resolution of pending and threatened litigation, and he directed the company's administrative and operational functions including development, construction, marketing, and sales.

His experience includes the following selected engagements:

- Mr. Farrell conducted cost audits of projects, both domestic and international, totaling in-place construction of over \$1 billion for various types of contracts ranging from cost plus to cost plus and incentives, to guarantee maximum price. Construction projects have ranged from wastewater treatment plants to hotels and luxury resorts, casinos, power plants, and prison facilities.
- Mr. Farrell has provided expert witness testimony in federal and state court, mediations, and arbitrations on direct and consequential damages in a broad range of industries. He has been engaged by private and public owners; local, regional, state, national, and international contractors and subcontractors; and architects and engineers.
- Mr. Farrell prepared and defined numerous claims for acceleration, delay, disruption, general cost overruns, loss of productivity, extend project and home office overhead, interest and profit as well as the costs incurred for scope modifications, for projects ranging from the remodeling of a rocket launch facility to the construction of prisons, school facilities, and military housing.
- He developed the policies and procedures for the implementation and management of the Chicago Public Schools \$1.5 billion capital improvement program for the construction of new schools, renovation of existing infrastructure, educational enhancements, and school security systems. Mr. Farrell's team established cost controls, developed contractor selection criteria, developed individual cost budgets for over 500 schools, and implemented administrative policies for bidding through project closeout.
- He examined the cost overrun from the delay, acceleration, and the lack of project cost controls in the construction of a new sophisticated emergency communication system and quantified the amount of the overrun results from billing errors, irregularities, and the failure to comply with the contract terms as well as illegal and unethical business practices.

His recent testimony experience includes: *North Central Construction, Inc. v. Quad County Corn Processors Cooperative*, American Arbitration Association, Des Moines, Iowa Arbitration Testimony; *Allegis Group, Inc. and Onsite Companies, Inc. v. Kevin Knaul, Kevin Brownsey, James Pagliero, Sean Rice, Franklin Leister IV, Hudson Highland Group, Inc. and TMP Worldwide, Inc.*, United States District Court, Illinois Eastern Division, No. 02-C-8192, Deposition Testimony; *Abbott & Cobb, Inc. v. Seminis Vegetable Seeds Inc.*, American Arbitration Association, San Francisco, California, Deposition and Arbitration

Testimony; *CapGemini America, Inc., A New Jersey Corporation v. National Research Corporation, A Wisconsin Corporation*, United States District Court, Nebraska, No. 4:00CV283, Deposition and Trial Testimony; *IBP, Inc. v. H.K. Systems, Inc.*, United States District Court, Nebraska, No. 8:98CV480, Deposition Testimony; *Raphael Lupo, et al v. Brinks Hofer Gilson and Lione, P.C.*, 1999, American Arbitration Association, Chicago, Illinois, Deposition and Arbitration Testimony.

He is the author of "Claims for Lost Profits," *Proving and Pricing Construction Claims, Aspen Law & Business*, 2001, as well as several other articles and texts. Other presentations he has made include "Whose Schedule Is It Anyway: Demystifying Scheduling," presented at the Practising Law Institute's Handling Construction Risks in New York, April 16, 2004; "Back to the Basics: Dealing with Federal Government Construction Contracts," presented at the "Owner's" Construction Superconference in San Francisco, December 12, 2003; "Forensic Construction Accounting and False Claims: It Cost How Much?," presented at the Practising Law Institute's Handling Construction Risks 2003 in New York, April 11, 2003; "Effectively Using Daubert and Kumho Tire in Construction Disputes: Keeping Your Expert In and Keeping the Subcontractors Expert Out," presented at The Contractor's Construction Superconference in San Francisco, December 12, 2002; "To Audit or Not? That's the Question," presented at the Society of Illinois Construction Attorneys in Chicago, July 9, 2002; "To Claim or Not to Claim—The Art of the Possible in Construction Disputes," presented for the Illinois Institute for Continuing Legal Education in Chicago, December 6, 2001; and "Construction Fraud," presented at the Conference for Catholic Facility Management in Indianapolis, June 2001.

Mr. Farrell holds a bachelor of science degree from Oregon State University, and he is a Certified Public Accountant in Illinois and California. He is a member of the American Institute of Certified Public Accountants, Illinois Society of Certified Public Accountants; California Society of Certified Public Accountants; and the American Bar Association.

Douglas L. Patin
Attorney
Bradley Arant Rose & White

Mr. Patin is one of the presenters for Workshop I, "Contractor Default Claims," on Wednesday morning. He recently joined the Bradley Arant Rose & White law firm after leading Washington, DC-based Spriggs & Hollingsworth's prominent construction practice. He also has an extensive nonconstruction government contracts practice. While Mr. Patin's legal profession has involved traditional construction and government contract disputes, he has developed a specialized expertise in various aspects of construction law including federal government contracts, builder's risk and liability insurance disputes, bid protests, bond claims, jury trials, and complex litigation involving fiduciary duty claims.

Mr. Patin's teaching and writing efforts keep him current on changing case law developments. He represented the owner of one of the largest construction projects in the United States (the Central Artery Tunnel in Boston), some of the largest general contractors and subcontractors in the country, and many smaller general contractors and subcontractors. He has several litigation achievements involving contractors issues to his credit.

Recently, Mr. Patin was rated among the leading construction lawyers in Washington, DC, by the publishers of *Chambers USA—American Leading Lawyers for Business*, 2005 edition.

Mr. Patin earned a bachelor of arts degree with highest honors from the University of Wisconsin—River Falls in 1976 and a juris doctor from George Washington University National Law Center in 1979.

MANAGING THE COMPLETION/ TAKEOVER PROCESS FROM THE OWNER'S AND SURETY'S POINTS OF VIEW

James V. Farrell
FTI

Douglas L. Patin
Bradley, Arant, Rose & White

I. Brief Introduction and Overview

II. Deciding How To Complete the Project—Surety's View

- A. Threshold legal issues
 - 1. Takeover surety vs. completing/financing surety
 - 2. Negotiating takeover agreement with owner
 - 3. Negotiating takeover of subcontract agreements
 - 4. Form of completion contract
 - 5. Recovery of claims issues (special federal contracts issues)
- B. Threshold business issues—how to complete the project
 - 1. Deciding what kind of completion contract should be chosen
 - 2. Practical tips in negotiating the completion contract
 - 3. Negotiating with subcontractors
 - 4. Investigating and reporting the financial status of project
 - 5. Projecting costs to complete
 - 6. Projecting time for completion
- C. How does a bankruptcy filing affect the decision-making process?

III. Managing the Completion of the Contract—The Surety's View

- A. Legal issues

1. Processing claims against the owner (federal contracting issues)
2. Claims against subcontractors and their sureties
3. Authority issues during completion

B. Business issues

1. Deciding on who speaks for the surety/clear lines of authority/decision-making
2. Retaining key personnel of defaulted contractor/cooperation of former personnel
3. Document control
4. Cost controls
5. Scheduling
6. Managing subcontractor and owner claims

IV. The Completion Process—Owner's Viewpoint

- A. What difference does it make to the owner on how the surety completes the project?
- B. What role, if any, can the owner have in deciding how the project is completed by the surety?
- C. What are the legal/business issues in negotiating a takeover agreement from the owner's view?
- D. How does a bankruptcy filing affect the owner's decision-making process?

V. What Are the Issues for a General Contractor in Having a Surety Complete a Defaulted Subcontractor's Work?

VI. Identifying the "Traps" in the Completion Process

- A. What are the legal "traps"?
- B. What are the business "traps"?

VII. Practice Pointer Checklist

MANAGING THE COMPLETION/ TAKEOVER PROCESS FROM THE OWNER'S AND SURETY'S POINTS OF VIEW

**James V. Farrell
FTI**

**Douglas L. Patin
Bradley, Arant, Rose & White**

Table of Contents

I. Introduction and Overview	9
II. Deciding How To Complete The Project—Surety's View.....	9
A. Pre-Bankruptcy Strategies	9
III. Equitable Subrogation Rights	10
A. Federal Contracting Limitations on Surety's Equitable Subrogation Rights	12
B. Takeover Issues—The Surety's View	13
C. Legal Issues—Federal Contracting	13
D. Application Of Bankruptcy Code's Provisions.....	16
E. Other Legal Issues—AIA Forms.....	18
IV. Takeover Agreements—Business Issues	19
V. Completing the Project—Owner's View	19

Notes

This file is set up for duplexed printing. Therefore, there are pages that are intentionally left blank. If you print this file, we suggest that you set your printer to duplex.

Managing The Completion/Takeover Process From The Owner's And Surety's Points of View

Introduction and Overview

Managing the completion of a contract after the default of a bonded general contractor is certainly one of the most complex and difficult challenges an owner or surety will ever face. The legal issues posed involve a complex, competing web of bankruptcy, assignment, suretyship, subrogation, construction, and government contract law issues which must be carefully analyzed and mapped out in advance to protect an owner's or surety's interests. Equally important are the myriad of business decisions an owner or surety must recognize and decide quickly, or else be faced with huge losses, which accumulate for every day of delay which occurs in the completion of the underlying contract. In practically every situation, time works against the owner and surety, who more often than not, do not have the staff or resources necessary to manage the process. This session will focus in on the situation where the viability of the contractor as an ongoing business is at risk, and the surety's general agreement of indemnity will not provide adequate protection for the surety's interest. We will address the legal and business issues which the owner and surety will face when managing the completion of a defaulted construction contract in such circumstances.

Deciding How To Complete The Project – Surety's View

Pre-Bankruptcy Strategies

The surety may not have clear warning signs that the contractor is in trouble financially. This situation may simply be precipitated by a parent company's financial problems which affect the contractor's credit lines. As soon as the surety sees warning signs, it needs to prepare itself by hiring necessary financial and legal consultants to map out a business and legal strategy.

Among the options to be considered by the surety is working cooperatively with the contractor's lenders to provide cash flow to maintain the progress of ongoing construction contracts to avoid the domino effect of multiple contract defaults leading to an inevitable bankruptcy filing by the desperate contractor. This process may require the negotiation of agreements with the banks over (1) how and when to provide cash to the contractor, and (2) which party has priority over the secured assets of the contractor.

In this pre-bankruptcy situation the surety must quickly assess whether the contractor's situation is capable of being worked out or whether the contractor's financial demise is inevitable. Making this basic initial assessment is essential for developing a strategy by the surety. The surety must have knowledgeable consultants review the status and health of the contractor's book of business, its cash flow, and its potential liabilities to owners, and liabilities to downstream parties, such as subcontractors and suppliers. These consultants must apply practical business and financial judgments in very short periods of time, with limited access to

necessary information to make informed judgments. Finding such capable, experienced consultants on short notice is no easy task. Thus, starting earlier, rather than later, is a must for the surety.

The basic tasks to undertake involve assessing:

- a) Status of completion for each major contract;
- b) Will the contract balance cover costs of completion for each contract;
- c) Status of claims upstream and downstream;
- d) Status of payables downstream;
- e) Collection of receivables on completed contracts;
- f) Cash flow projections generally;
- g) Obligations to lenders and any other secured creditors;
- h) Can the contractor retain key personnel.

Thus, both the surety and the contractor's lenders may find it in their common interests to finance the contractor through what they assess to be "temporary difficulties," realizing that there is far more risk and exposure in having the contractor file bankruptcy. This effort requires an assessment of what key personnel are necessary to retain. Guarantees need to be extended to key employees. If the contractor's key personnel cannot be retained, the surety's and lenders' efforts to see the contractor through temporary difficulties will ultimately be frustrated. Neither a surety nor a lender can keep a contractor afloat without the contractor's key personnel.

By helping the contractor avoid default with pre-bankruptcy financing, the surety can avoid the greater exposure it will have on the performance bond if there are delays, and multiple contractor defaults. For example, the cost of financing a distressed contractor may be far less by maintaining the existing fixed price obligations of its lower tier subcontractors and suppliers, than if the surety has to negotiate completion agreements with those parties after default.

Legally, the surety should consider taking UCC Article 9 security interests in the debtor's equipment, unsecured assets, receivables or assignment of other assets to solidify its position in the face of a pending bankruptcy.

Equitable Subrogation Rights

In addition, the surety must assess the value of its equitable subrogation rights if it chooses to finance the contractor prior to a bankruptcy filing by the contractor. Generally, a surety that performs under a bond due to its principal's default under the bonded contract is equitably subrogated to the rights of the principal (the contractor) and the obligee (the owner), and other beneficiaries of the payment bond, such as subcontractors and suppliers the surety has paid. See Restatement of Suretyship §§ 27, 53, 59. Subrogation substitutes the surety for the other parties benefiting from the surety's performance of the bond and vests the surety with such parties' claims and rights. See, e.g., Ammerman v. Miller, 488 F.2d 1285 (D.C. Cir. 1973); National Shawmut Bank of Boston v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); Trinity Universal Ins. Co. v. United States, 382 F.2d 317 (5th Cir. 1967); First Alabama Bank of Birmingham v. Hartford Accident & Indemnity Co., 430 F. Supp. 907 (N.D. Ala. 1977); McAtee v. United States Fidelity and Guaranty Co., 401 F. Supp. 11 (N.D. Fla. 1975); Menorah Nursing

Home v. Zukov, 548 N.Y.S.2d 702 (N.Y. App. Div. 1989); American Ins. Co. v. Ohio Bureau Workers' Compensation, 577 N.E.2d 756 (Ohio App. 1991); Maryland Casualty Co. v. King, 381 P.2d 153 (Okla. 1963).

The traditional elements of equitable subrogation are: (1) the principal's obligation; (2) the principal's failure to perform; (3) the obligee's rights arising from the principal's failure to perform; and (4) performance by the surety extinguishing the obligee's rights. See, e.g., Fidelity & Deposit Co. of Maryland v. Scott Brothers Construction Co., 461 F.2d 640 (5th Cir. 1972); First Alabama Bank, 430 F. Supp. at 911-12; District of Columbia v. Aetna Ins. Co., 462 A.2d 428 (D.C. 1983).

When the debtor/contractor defaults, and the surety pays the open bills on the job and pays to complete the job, the surety "stands in the shoes of the contractor insofar as there are receivables due it; in the shoes of laborers and materialmen who have been paid by the surety-who may have had liens; and, not least, in the shoes of the [owner], for whom the job was completed." National Shawmut Bank, 411 F.2d at 845. Without limitation, the surety holds an equitable lien on all bonded contract proceeds that its performance makes available. See In re Merts Equipment Co., 438 F. Supp. 295 (M.D. Ga. 1977).

The United States Supreme Court recognized in Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962), that the surety's equitable subrogation rights had priority over the trustee of the principal's bankruptcy estate. See also In re E.R. Fegert, Inc., 88 B.R. 258 (9th Cir. B.A.P. 1988), aff'd, 887 F.2d 955 (9th Cir. 1989); In re Ward Land Clearing & Drainage, 73 B.R. 313 (N.D. Fla. 1987); Matter of Don's Elec., Inc., 65 B.R. 399 (W.D. Wis. 1986); In re Alliance Properties, Inc., 104 B.R. 306 (Bankr. S.D. Cal. 1989); In re Pacific Marine Dredging and Construction, 79 B.R. 924 (Bankr. D. Or. 1987); see generally In re Wingspread Corp., 145 B.R. 784 (S.D.N.Y. 1992).

Generally, a right of equitable subrogation will have priority over the liens and security interests of the debtor's bank lender and other secured creditors. Subrogation rights may relate back to the date the surety issued its bond. In any event, equitable subrogation rights will have priority over a lien or security interest in the debtor's property, even if the lien or security interest attached and was perfected before the surety issued the bond. See, e.g., Fidelity & Deposit, 461 F.2d at 642; First Alabama Bank v. Hartford, 430 F. Supp. at 911-12; Pacific Marine, 79 B.R. at 929; Mid-Continent Casualty Co. v. First National Bank and Trust Co. of Chickasha, 531 P.2d 1370 (Okla. 1975).

The conflict most often will arise between the surety and a lender with a security interest in the debtor's accounts receivable. Certain conditions apply to the surety's priority. First, because the surety's subrogation rights only arise upon default, the surety's rights attach only to post-default receivables under the bonded contract. Accordingly, the lender's security interest may have priority with respect to payments earned by the contractor before default and the surety's priority may be limited to payments earned after default. See Fidelity & Deposit, 461 F.2d at 642-43; National Shawmut Bank, 411 F.2d at 848; First Alabama Bank, 430 F. Supp. at 911-12. Second, because the extinguishment of the obligee's rights is a necessary element of equitable subrogation, the surety's subrogation rights do not arise if the surety fails to pay the obligee in full. See National Surety Corp. v. Cherokee County Bank, 57 F. Supp. 370 (N.D. Ala. 1944).

Subrogation rights generally will arise under an agreement of indemnity executed by the debtor in connection with the issuance of the bond. The surety may have additional rights, liens and security interests against the debtor and its property under separate financing and security agreements. The surety's non-subrogation rights vis-a-vis the estate and other secured creditors will be determined by Article 9 of the Uniform Commercial Code and other applicable state law.

Federal Contracting Limitations on Surety's Equitable Subrogation Rights

Under a federal construction contract, when a surety elects to finance the contractor through completion of the project, it typically requests the contracting agency to cease making payments to the contractor and instead direct them to the surety. However, as a general rule the government is not required to honor the surety's request and may continue making payments to the contractor as work is completed, as long as performance is satisfactory to the government and the government has good reason to believe that the contract will be completed. Royal Indem. Co. v. U.S., 529 F.2d 1312, 1321 (Ct. Cl. 1976); see also Balboa Ins. Co. v. U.S., 775 F.2d 1158 (Fed. Cir. 1985). In Balboa, the Federal Circuit identified the following eight factors courts should consider in determining whether the government exercised reasonable discretion in distributing funds:

- 1) attempts by the government, after notification by the surety, to determine whether contractor had the capacity and intent to do the job;
- 2) percentage of contract performance completed at the time of the surety's notification;
- 3) the government's efforts to determine the progress made on the contract after notification by the surety;
- 4) whether the contract was subsequently completed by the contractor;
- 5) whether the payments to the contractor subsequently reached the subcontractors and suppliers;
- 6) whether the government had notice of problems with the contractor's performance previous to the surety's notification of default to the government;
- 7) whether the government's action violates one of its own statutes or regulations;
- 8) evidence that the contract could or could not be completed as quickly or cheaply by a successor contractor. Id. at 1165.

A surety may obtain the status of a completing surety by financing an insolvent contractor to complete performance. Aetna Casualty & Sur. Co. v. U.S., 845 F.2d 971 (Fed. Cir. 1988); Great Am. Ins. Co. v. U.S., 481 F.2d 1298 (Ct. Cl. 1973); Morgenthau v. Fidelity & Deposit Co., 94 F.2d 632 (D.C. Cir. 1937); Morrison Assurance Co. v. U.S., 3 Cl. Ct. 626 (1983).

Once established as a completing surety, the surety has certain priority rights over retained contract funds. For example, a performance bond surety has priority to retained funds and remaining progress payments over the IRS' claims for taxes. Trinity Universal Ins. Co. v. U.S., 382 F.2d 317 (5th Cir. 1967); Security Ins. Co. v. U.S., 428 F.2d 838 (Ct. Cl. 1970) (performance bond surety entitled to retainage free from setoff for taxes). A payment bond surety, on the other hand, is not granted such priority over the IRS. United States Fidelity & Guar. Co. v. U.S., 475 F.2d 1377 (Ct. Cl. 1973). A surety that has fulfilled its bond obligations has priority to retained funds over the claims of the defaulted contractor or the contractor's trustee in bankruptcy. Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962).

Before any equitable subrogation rights arise, the surety must give notice to the government that the contractor is in default and cannot complete the contract. Fireman’s Fund Ins. Co. v. United States, 909 F.2d 495 (Fed. Cir. 1990); American Ins. Co. v. United States, 62 Fed. Cl. 151 (2004).

Upon default of the contractor the surety seeking payments through its equitable rights of subrogation is generally limited to recovery of the contract balance held by the government at the time of default. Dependable Ins. Co. v. U.S., 846 F.2d 65 (Fed. Cir. 1988); Balboa Ins. Co. v. U.S., 775 F.2d 1158 (Fed. Cir. 1985); Peerless Ins. Co., ASBCA 28887 88-2 BCA ¶ 20,730.

Recent cases from the Federal Circuit establish that a surety’s equitable subrogation rights do not establish jurisdiction before the Boards of Contract Appeals for the surety to claim subrogation rights in claims the contractor may have had against the government prior to default, and prior to the execution of a takeover agreement. Fireman’s Fund Ins. Co. v. England, 313 F.2d 1344 (Fed. Cir. 2002); United Pacific Ins. Co. v. Roche, 380 F.2d 1352 (Fed. Cir. 2004). These cases deal with the Boards’ jurisdiction under the Contract Disputes Act. They do not address the surety’s equitable subrogation rights under the Tucker Act, which permit equitable subrogation claims against the United States in the United States Court of Federal Claims. American Ins. Co. v. United States, 62 Fed. Cl. 151 (2004); Balboa Ins. Co. v. United States, 775 F.2d 1158, 1160 (Fed. Cir. 1985); Transamerica v. United States, 989, F.2d 1188 (Fed. Cir. 1993).

Takeover Issues – The Surety’s View

Once the contractor is declared in default, the surety must decide whether to enter into a takeover agreement with the owner, complete the project through other means (*i.e.*, tender a completion contract to owner), or dispute the default and litigate the merits of the default with the owner. This section will focus on the issues facing the surety once it decides to enter into a takeover agreement with the owner.

Legal Issues – Federal Contracting

The surety does not have an absolute right to complete the work. The government’s options regarding completion of the work, under a fixed-price contract, appear at FAR 49.404(b)-(c):

(b) Since the surety is liable for damages resulting from the contractor’s default, the surety has certain rights and interests in the completion of the contract work and application of any undisbursed funds. Therefore, the contracting officer must consider carefully the surety’s proposals for completing the contract. The contracting officer must take action on the basis of the Government’s interest, including the possible effect upon the Government’s rights against the surety.

(c) The contracting officer should permit surety offers to complete the contract, unless the contracting officer believes that the persons or firms proposed by the surety to complete the work are not competent and qualified or the proposal is not in the best interest of the Government.

While the FAR provides that the government should normally permit the surety to complete the work, the government is not required to do so. The contracting officer has the discretion not to

terminate the contractor and to continue making payments to the contractor as long as the decision is not arbitrary and capricious and does not disregard the rights of the surety. Royal Indem. Co. v. U.S., 529 F.2d 1312 (Ct. Cl. 1976); Argonaut Ins. Co. v. U.S., 434 F.2d 1362 (Ct. Cl. 1970).

In Mid-Continent Casualty Co., DOTBCA 1996, 89-3 BCA § 22,120, the government terminated the prime contractor for default and elected to rebid completion of the project. The surety argued that it had a right to take over the work and complete the project. The contracting officer rejected this contention. The surety appealed, requesting that the Board find that the surety's liability under the performance bond was limited to its estimate of what the work would have cost it to complete versus the actual cost to complete the work through reprocurement. The Board dismissed the surety's claim for lack of jurisdiction under the Contract Disputes Act because the surety was not a party to the contract. Furthermore, the Board noted that the surety's claim was not proper under the equitable doctrine of subrogation. This doctrine permits a surety that has fulfilled its obligations under a bond to recover retained contract funds. Because the surety in this case was not seeking to recover contract funds, but to limit its liability by being awarded the contract, the surety's claim was not proper as a subrogation right. *Id.* at 111,243.

The effect of a takeover agreement is to place the surety in the shoes of the original contractor, with the surety assuming all the contractor's rights and obligations under the construction contract. Carchia v. U.S., 485 F.2d 622 (Ct. Cl. 1973); Golden Gate Bldg. Maintenance Co., ASBCA 12202, 68-1 BCA ¶ 6739.

The mandatory provisions of a takeover agreement for a Federal construction contract are set forth in the FAR 49.404(e):

- (e) Any takeover agreement must require the surety to complete the contract and the Government to pay the surety's costs and expenses up to the balance of the contract price unpaid at the time of default, subject to the following conditions:
 - (1) Any unpaid earnings of the defaulting contractor, including retained percentages and progress estimates for work accomplished before termination, must be subject to debts due the Government by the contractor, except to the extent that the unpaid earnings may be used to pay the completing surety its actual costs and expenses incurred in the completion of the work, but not including its payments and obligations under the payment bond given in connection with the contract.
 - (2) The surety is bound by contract terms governing liquidated damages for delays in completion of the work, unless the delays are excusable under the contract.
 - (3) If the contract proceeds have been assigned to a financing institution, the surety must not be paid from unpaid earnings, unless the assignee provides written consent.
 - (4) The contracting officer must not pay the surety more than the amount it expended completing the work and discharging its liabilities under the

defaulting contractor's payment bond. Payments to the surety to reimburse it for discharging its liabilities under the payment bond of the defaulting contractor must be only on authority of -

- (i) Mutual agreement among the Government, the defaulting contractor, and the surety;
- (ii) Determination of the Comptroller General as to payee and amount; or
- (iii) Order of a court of competent jurisdiction.

While the FAR does not permit the government to waive or reduce liquidated damages in a takeover agreement, it does not prohibit the negotiation of a revised completion date.

A takeover surety may not pursue a claim against the federal government for events predating the takeover agreement under the Contract Disputes Act. Nor can the surety be assigned pre-takeover agreement claims because of the Anti-Assignment Act. United Pacific Ins. Co. v. Roche, 380 F.3d 1352 (Fed. Cir. 2004); Fireman's Fund Ins. Co. v. England, 313 F.2d 1344 (Fed. Cir. 2002).

However, a surety can effectively pursue pre-takeover contractor claims by seeking appointment as an estate representative of the debtor contractor. Section 1123(b)(3) of the Bankruptcy Code provides that a plan may provide for settlement of claims belonging to the debtor or the estate or the retention and enforcement of such claims by the debtor, the trustee or a representative of the estate appointed for such purpose. The trustee is the representative of the estate generally and may sue or be sued in such capacity. See 11 U.S.C. § 323. The debtor-in-possession has the rights, powers and duties of a trustee pursuant to Section 1107 of the Bankruptcy Code, including the capacity to sue and be sued during the chapter 11 case. Section 1123(b)(3)(B) permits the chapter 11 plan to provide for a representative of the estate to pursue causes of action not settled or pursued by the trustee or the debtor post-confirmation. See, e.g., In re Sweetwater, 884 F.2d 1323 (10th Cir. 1989); In re Morning Treat Coffee, Co., 77 B.R. 62 (Bankr. M.D. La. 1987); In re Tennessee Wheel & Rubber Co., 64 B.R. 721 (Bankr. M.D. Tenn. 1986).

The concept of benefit to the estate under Section 1123(b)(3)(B) should be interpreted broadly. See In re Churchfield Management & Investment Corp., 122 B.R. 76 (Bankr. N.D. Ill. 1990). The estate will benefit from the increase of the value of the debtor's bonded contract claims and the decrease in the surety's deficiency claim. See, e.g., Committee of Unsecured Creditors of Specialty Plastic v. Doemling, 127 B.R. 945 (W.D. Pa.), aff'd, 952 F.2d 1391 (3d Cir. 1991). The estate may also benefit from its residual interest in recoveries above the amount of the surety's claims. Accordingly, appointment of a surety with the funding, expertise and motivation to pursue bonded contract receivables may be appropriate under Section 1123(b)(3)(B).

The specificity required to retain a cause of action under Section 1123(b)(3)(B) is the subject of disagreement among courts. Some courts find a general reservation of rights as to particular types of actions is sufficient. Other courts suggest each claim or defendant must be identified with specificity. Compare In re USN Communications, Inc., 280 B.R. 573 (Bankr. D. Del. 2002) with In re Goodman Bros. Steel Drum Corp., Inc., 247 B.R. 604 (Bankr. E.D.N.Y. 2000). Local decisions tend toward specificity. See SouthTrust Bank, N.A. v. WCI Outdoor Prods., Inc. (In re Huntsville Small Engines, Inc.) 228 B.R. 9 (Bankr. N.D. Ala. 1998). Accordingly, the defendant

may argue the debtor failed to retain a claim under Section 1123(b)(3)(B) if the claim is not sufficiently identified in the plan. See Harstad v. First American Bank, 39 F.3d 898 (8th Cir. 1994). However, appointment in the plan of a third-party representative should preempt any claim by the defendant that the representative lacks standing. See, e.g., Mako, 985 F.2d at 1055; In re Chase & Sanborn, Corp., 813 F.2d 1177 (11th Cir. 1987); In re Hooker Investments, Inc., 162 B.R. 426 (Bankr. S.D.N.Y. 1993).

In any claim against the federal government over \$100,000, the claim must be certified. Thus, the surety must appoint a person with authority to certify claims arising after the takeover agreement is signed. The surety must screen claims to insure they meet the good faith standards of certifications under the Contract Disputes Act, and that they do not run afoul of the False Claims Act, or Forfeiture Act.

Application Of Bankruptcy Code's Provisions

Section 365(e)(1) of the Bankruptcy Code provides that notwithstanding any provision in the contract or applicable law, an executory contract of the debtor may not be terminated after commencement of the case solely because of a provision in the contract conditioned upon the insolvency or financial condition of the debtor or the commencement of the bankruptcy case. Section 365(e)(1) invalidates not only express ipso facto clauses but also provisions that have the same practical effect, even if they do not specifically refer to bankruptcy or insolvency. See In re Thomas B. Hamilton Co., 969 F.2d 1013 (11th Cir. 1992). Section 365(e)(2) provides that the invalidation of ipso facto clauses does not apply to contracts that are not assignable under applicable law. Applicable law may include the federal anti-assignment act (41 U.S.C. § 15) and state partnership statutes that excuse the counterparty from accepting performance from or rendering performance to an assignee. Accordingly, a debtor/contractor's contracts with the federal government, and its joint venture agreements with other contractors, may be subject to termination under 365(e)(2). Termination under 365(e)(2) remains subject to the automatic stay, but if subsection (e)(2) applies the court may find cause to lift the stay to allow the counterparty to terminate. See In re Siegal, 190 B.R. 639 (Bankr. D. Ariz. 1996).

A number of courts have recognized – albeit more often in theory than in application – that the stay may apply to claims against non-debtor third parties and non-estate assets in unusual circumstances. In re A. H. Robbins, 788 F.2d 994 (4th Cir. 1986); see also Queenie, Ltd. v. Nygard International, 321 F.3d 282 (2d Cir. 2003); McCartney v. Integra Nat'l Bank North, 106 F.3d 506 (3d Cir. 1997). These courts start from the proposition that the stay should be broadly construed to give the debtor a breathing spell and promote efficiency of administration. In appropriate cases, efficient administration of the debtor's bankruptcy case may require consolidating all disputes and litigation in the bankruptcy court. See In re Ionosphere Clubs, Inc., 922 F.2d 984 (2d Cir. 1990). Courts have stayed actions against non-debtor insiders, such as executives, principals and owners necessary to formulating, funding and implementing the debtor's reorganization, on the theory that third-party litigation would drain time, attention and resources vital to the debtor's cases. See, e.g., In re Eagle-Picher Industries, 963 F.2d 855 (6th Cir. 1992); In re American Film Technologies, Inc., 175 B.R. 847 (Bankr. D. Del. 1994); In re Lazarus Burman Assocs., 161 B.R. 891 (Bankr. E.D.N.Y. 1993); In re F.T.L. Inc., 152 B.R. 61 (Bankr. E.D. Va. 1993).

Other courts have recognized that unusual circumstances sufficient to stay actions against non-debtor third parties may exist where the third party is entitled to an absolute indemnity from the debtor such that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor. A. H. Robbins, 788 F.2d at 99; see also McCartney, 106 F.3d at 509 (staying action on defaulted loan guaranteed by debtor because debtor ultimately would be liable for deficiency); In re Midway Airlines Corp., 283 B.R. 846 (E.D. N.C. 2002) (stay applies to claims against insiders covered by debtor's liability insurance policy because indemnification claims could diminish estate to detriment of creditors); In re Veliotis, 79 B.R. 846 (Bankr. E.D. Mo. 1987) (stay applies to lawsuit when judgment against non-debtor in effect is judgment against debtor and claim against estate); see generally In re Family Health Services, Inc., 105 B.R. 937 (Bankr. C.D. Cal. 1989) (stay barred claims against members and enrollees of debtor health maintenance organization).

A surety with an absolute common law and contractual right to indemnity from the debtor would seem to fit the Robbins court's definition and illustration of "unusual circumstances" justifying the stay of actions against third parties. The surety and the debtor are bound by law and contract so that the liability of the former is imputed to the latter and third-party litigation would be binding on the estate if not stayed. See Robbins, 788 F.2d at 799. Nevertheless, while reported decisions holding that the stay does not apply to claims against sureties are easy to find, decisions extending the automatic stay to sureties are scarce. Decisions staying proceedings against sureties in other contexts are based on facts or reasoning not always applicable in a bankruptcy case. See U.S. Bank v. Royal Indemnity, 2002 W.L. 31114069 (N.D. Tex. 2002); United States v. William F. Wilkie, Inc., 685 F. Supp. 936 (D. Md. 1988).

A bankruptcy court clearly has jurisdiction to stay actions against non-debtor sureties. See Celotex Corp. v. Edwards, 514 U.S. 300 (1995). Celotex involved over 200 bonded judgment creditors seeking authority to execute on supersedeas bonds. The Court declined to address the merits of the injunction at issue, but recognized execution would have a direct and substantial negative impact on the debtor's ability to reorganize. Though failing to rule on the particular injunction imposed by the bankruptcy court, the Court noted the bankruptcy court had authority to issue an injunction given the large number of claims and the effect on the debtor's reorganization. See Celotex, 514 U.S. at 310-11. A bankruptcy judge will have the discretion, therefore, to determine whether the particular circumstances presented are sufficiently unusual to stay actions against the debtor's sureties. Primary factors will include the number of claims, the effect on the debtor's estate and the prejudice to creditors.

In one major contractor bankruptcy case, the contractor debtor argued in favor of a temporary stay of claims against their sureties to protect the value of the debtors' book of litigation as an asset of the estate. See, e.g., Eastern Airlines v. Rolletson (In re Ionospheres Clubs, Inc.), 111 B.R. 423 (Bankr. S.D. N.Y. 1990) (stay protects assets from dissipation and administrative interference and prevents creditors from reaching assets through piecemeal litigation). In support of its motion, the debtors presented evidence that (i) they were party to over 200 construction-related actions in various jurisdictions across the country; (ii) the actions involved affirmative claims and counter-claims by the debtors as well as claims against the debtors; (iii) the claims, as a whole, had significant net value to the debtors' estates (in excess of \$100 million); (iv) piecemeal litigation of the claims in venues across the country significantly would impair the debtors' ability to manage the litigation and would reduce the value of the estates' interests; (v)

without limitation, the debtors did not have funding to litigate the claims and needed time to negotiate appropriate funding with their sureties and secured lenders; and (vi) given the size, complexity and geographic scope of the litigation, all parties in interest would benefit from a breathing spell to allow the formulation of a coherent, comprehensive litigation management plan. The bankruptcy court stayed all litigation involving the debtor's construction projects, including all claims against the debtors' sureties, for a period of approximately five months to allow the debtors to formulate a comprehensive litigation plan. Thereafter, the court vacated the temporary stay, granted limited stay relief with respect to bonded litigation and statutory lien claims and established removal and other deadlines for all litigation pursuant to the debtor's proposed litigation management plan.

Other Legal Issues - AIA Forms

The AIA General Conditions of the Contract for Construction (AIA Document A201-1997), which are adopted by reference into several of the AIA's standard form agreements, grant the owner the right to require the contractor to furnish performance and payment bonds. Article 11.5.1, AIA A201. The AIA's Performance Bond, AIA Document A312-1984, provides that the surety's obligation under the bond does not arise until, among other things, the owner has given notice of the potential default, attempted to confer with the contractor and surety on methods of performance, declared the contractor in default and formally terminated his right to complete the contract, and agreed to pay the balance of the contract price to the surety or the takeover contractor. Article 3, AIA312. Once the owner has fulfilled these prerequisites, the AIA performance bond gives the surety four options: (1) with the owner's consent, arrange for the contractor to perform and complete the job; (2) take over performance; (3) obtain bids from other contractors acceptable to the owner to perform the remaining work, and pay the owner the amount in excess of the balance of the contract price incurred by the owner as a result of the default; or (4) waive its right to elect items (1) - (3), and, after investigation, either tender payment to the owner in the amount for which the surety has determined it is liable or deny liability and notify the owner of its grounds for denial. Article 4, AIA312. The surety must proceed with performing one of these options with reasonable promptness, or, fifteen days after receipt of written notice from the owner, the surety shall be deemed in default. Article 5, AIA312.

If the surety elects to arrange for completion, perform and complete, or obtain a new contractor, AIA312 provides that the surety is liable to the owner, up to the limit of the bond amount, and subject to commitment by the owner of the balance of the contract price to "mitigation of costs and damages" on the contract, for, among other things, the contractor's obligation to correct defective work, additional legal, design professional and delay costs resulting from the default, and liquidated damages as provided in the contract, or, if none are provided, actual damages caused by delayed performance or non-performance. If the surety waives its right to complete the contract by any of the three enumerated options, the bond provides that the owner is entitled to proceed to enforce any remedy available to it without further notice to the surety. Article 6, AIA312.

Takeover Agreements – Business Issues

The surety must decide the form of contract it will enter into to finish the project after it enters into a takeover agreement with the owner. The following options all have their various business risks and rewards:

- 1) Enter into direct contracts with subs and suppliers;
- 2) Enter into fixed price contract with general contractor to complete;
- 3) Enter into cost reimbursable CM contract with general contractor to complete.

With any cost reimbursable arrangement the surety wants to incentivize the CM or completing contractor to complete on time and within certain budgets. The surety wants to be involved in deciding what subcontractors to retain and whether ratification agreements will be signed with the subcontractors.

The surety must look to retain key personnel from the defaulted contractor, establish budgets, schedules, and relationships with the owner.

The surety must decide what claims to pursue upstream and downstream and make sure that the upstream and downstream claims do not run afoul of each other.

The surety must assign someone with authority to deal with the owner, takeover contractor, and completing subcontractors.

The surety must establish cost controls, cost accounting and reporting procedures, and document control and retention. Normally, the surety does not have the resources available to manage a major takeover contract and will have to hire consultants to assist in the process.

Completing The Project – The Owner’s View

The owner has a definite interest in how the surety selects the completing contractor. While it cannot dictate who completes on behalf of the surety, it can register reasonable objections. For example, an owner may not want the surety to hire the defaulted contractor to complete, or some unqualified or disreputable contractor.

The surety wants to negotiate a fair takeover agreement which encourages the surety to complete, while protecting the owner’s rights to collect damages resulting from the contractor’s default.

Notes

This file is set up for duplexed printing. Therefore, there are pages that are intentionally left blank. If you print this file, we suggest that you set your printer to duplex.