NURSE HIM OR CURSE HIM: FACING SUBCONTRACTOR DEFAULT

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I. NATURE OF THE PROBLEM

Subcontractor default is an unavoidable fact of life in the construction industry for no matter how carefully the contractor investigates and selects subcontractors and suppliers, inevitably, some will fail to complete their work.[1]

The normal risk of subcontractor default is enhanced by the marginal economic conditions that have prevailed in the construction industry during the last several years. The weak economy has created new, unknown and untested firms bidding against better known and well-established subcontractors. Further, many subcontractors, both new and old, are quoting very low prices in order to obtain work, keep their best people, etc. Hence, the twin products of a bad construction climate — new and unknown subcontractors bidding unrealistically low prices — are likely to enhance the risk of subcontractor default.

How can the contractor handle the potential of subcontractor default, recognizing that it cannot entirely be eliminated? First, the contractor should assess the problem as he would assess any construction problem; that is, what risks are likely to result from a subcontractor's default?

Generally, the risks associated with subcontractor default can be placed into the following three categories:

A. *Payment Claims:* When a subcontractor defaults on a project, particularly if the default occurs well after the subcontractor has begun performance, the contractor is likely to face payment claims from the subcontractor's subsubcontractors, suppliers and materialmen who have not been paid. These claimants usually will seek to recover the monies they are owed under the mechanic's lien statute or state or federal payment

[1] As used herein, the term "subcontractor" refers to subcontractors and suppliers. The term "contractor" refers to the general contractor or prime contractor.

bond statutes. As a result of such claims, the contractor may have to pay twice, that is, pay the claimants notwithstanding the fact that he has already paid the subcontractor for the work performed or materials furnished by the claimants. The risks associated with payment claims upon default are compounded if the defaulting subcontractor is performing work on more than one of the contractor's jobs and/or the claimants are selling to the defaulting subcontractor for more than one project. The liberality with which the federal Miller Act and some state "Little Miller Acts" are construed by the courts may mean that the contractor or his surety must honor payment claims asserted by suppliers for materials delivered to the defaulting subcontractor's other projects.

B. *Performance Claims:* The default of the subcontractor can result in a number of serious performance problems which expose the contractor to considerable risks. These include:

1. Bid Withdrawal: Occasionally, a subcontractor who is low bidder, and whose bid was used by the contractor, will withdraw his bid, after award of the contract by the owner, citing as the basis for withdrawal a mistake in the bid or some other excuse. In the face of such a problem, the contractor may have to procure the services of another subcontractor whose bid will be higher; the contractor, however, generally will be unable to recover the difference in bids from the owner. As discussed below, however, the contractor may have a remedy against the subcontractor who defaults by withdrawing his bid;

2. Increased Completion Costs: When a major subcontractor defaults in performance, the contractor may incur increased costs in completing the subcontractor's work. These costs may exceed the undisbursed subcontract funds, as a result of which the contractor must expend his own monies to complete the work. Further, the default of a major subcontractor, often preceded by poor and untimely performance, may result in a delay to the entire project which exposes the contractor to the owner's claim for liquidated or

actual damages and the delay claims of other subcontractors; and

3. Warranty Claims: If the subcontractor does not default until after completion, the contractor still faces the possibility that a warranty claim relating to the subcontractor's work will not be honored because he is no longer in business.

C. *Claims of the Defaulting Subcontractor*: Such claims include:

1. Delay Claims: Occasionally, subcontractors who default in their performance will assert delay claims against the contractor in an effort to recoup some of their losses. Sureties of defaulting subcontractors sometimes will assert delay claims in an effort to minimize their losses on a payment or performance bond. Hence, the contractor is exposed to the costs of defending against such claims and possible liability; and

2. Wrongful Termination Claims: The contractor who terminates a subcontractor for default may find that he is the target of a claim for "wrongful termination": that is, the subcontractor who has been terminated may contest the validity of the termination and seek to hold the contractor liable for breach of contract.

The three categories of risks associated with subcontractor default suggest that the nature of the risk often will depend upon the stage of construction at which the subcontractor defaults. For example, if the project is in the bidding stage, the risk of default is likely to be withdrawal of the bid. Once the project is underway, the risks change to payment claims and performance claims. When the project is completed, the risks change again to the defaulting subcontractor's possible delay claim, his refusal (or inability) to perform warranty work and his claim against the contractor for wrongful termination.

In the remainder of these materials, we shall examine in greater detail the risks associated with subcontractor default. To help the contractor minimize these risks, if not eliminate them entirely, the materials offer suggestions to be followed in negotiating the subcontract and in monitoring the subcontractor's performance. It must be emphasized that no amount of diligence and good contract administration can completely eliminate the risk of

subcontractor default. However, the prudent contractor can substantially diminish the risks associated with default by effective contract negotiation and contract administration.

II. THE RISK OF BID WITHDRAWAL

A. Introduction

The contractor who desires to submit a bid to, or negotiate with, the owner must first estimate the cost of performing the work. To compute the overall cost of construction, the contractor will solicit and receive bids for those portions of the work to be subcontracted to firms specializing in the various trades.[2]

The contractor's receipt of subcontractor bids is usually conducted by telephone. The contractor selects the lowest bid and includes that bid in his bid to the owner. The low-bidding contractor will subsequently subcontract the specialized portions of the work to the subcontractors who submitted the lowest bids for their respective trades and whose bids were used in computing the bid to the owner.

This is the way the system works in theory and, usually, in practice. However, occasionally, a contractor who has used the low bid of a particular subcontractor and is awarded the contract will receive a letter from the subcontractor similar to one of the following:

[2] The problem addressed by this section of the materials is confined to that of subcontractors bidding to provide services or labor, a problem uniformly not covered by statute in any state. The analogous problem of subcontractors bidding to supply goods or materials is governed by the Uniform Commercial Code as enacted in a particular jurisdiction and is beyond the scope of these materials.

What are the rights of the contractor who has received such a letter and whose low bid to the owner included the telephone bid of a subcontractor who later wants to revoke his bid?

The contractor's right to enforce the telephone bid generally will depend on the law of the jurisdiction in which the bid is received and whether that jurisdiction follows traditional contract principles or has adopted the theory of promissory estoppel.

In those jurisdictions which still observe common law contract principles, the contractor will have to do more than merely demonstrate that he used the subcontractor's bid in his bid to the owner. These jurisdictions still require an offer and an acceptance in order to find a contract that can be enforced. Mere use of the subcontractor's bid will not be a sufficient acceptance giving rise to a contract. Instead, the contractor will have to demonstrate some other mode of acceptance; for example, a letter of intent or directive to the subcontractor to pull the permits, or the fact that the subcontractor began shop drawings.

In those jurisdictions which have adopted the theory of promissory estoppel, the contractor will have a better chance of enforcing the subcontractor's telephone bid.[3] In order to do so, the contractor must demonstrate that (1) the subcontractor made an offer (bid) to the contractor, (2) reliance on the offer by the contractor could be foreseen by the subcontractor, (3) the contractor justifiably relied on the bid; and (4) the reliance was to the contractor's detriment. The contractor can use evidence of trade custom to prove his justifiable reliance on the bid.

In a third category of jurisdictions, the appellate courts have not yet decided a case involving the withdrawal of a telephone bid; however, the cases in these jurisdictions suggest that they would apply promissory estoppel in such a situation.

B. The Traditional Approach

[3] Some of the jurisdictions which have applied the doctrine of promissory estoppel to a subcontractor bid withdrawal are New Jersey, Pennsylvania, New York, Arkansas, California, Minnesota, Texas, Maryland, and Hawaii.

The rationale underlying the common law approach is best exemplified by the 1933 case of *James Baird Co v. Gimbel Bros*. Gimbel Bros., bidding for a linoleum subcontract, had an employee compute the amount of linoleum required for the job. The employee under-estimated the total yardage by about one-half of the amount of the bid, but his mistake was not discovered until after Gimbel had sent its bid to twenty or thirty contractors bidding for the contract. Baird, one contractor, received Gimbel's bid on the same day that Gimbel discovered its mistake. Baird was unaware of the mistake and submitted its lump-sum bid to the owner based on Gimbel's bid. Baird's bid was accepted by the owner two days later. After another day had passed, Baird received a confirmation of the subcontractor's withdrawal. Within a week, the contractor formally accepted the subcontractor's offer. The subcontractor refused to perform and Baird brought suit for damages seeking to recover the difference between Gimbel's bid and the bid of the next-lowest subcontractor.

In its lawsuit, Baird contended that a contract was formed when it submitted the overall bid, based on Gimbel's bid to the owner, because this act was done before notice of revocation by the subcontractor. The subcontractor, however, relying upon traditional contract principles, argued that no contract existed because it had revoked its bid before it was accepted by Baird.

Judge Learned Hand found that Gimbel's bid contemplated communication of an acceptance after award of the contract by the owner. The offer by Gimbel to Baird was a promise, and a return promise by Baird to Gimbel was contemplated as the consideration to form a contract. The act of using the bid, itself, was not the anticipated mode of acceptance and, therefore, did not supply the necessary consideration to form a contract. Later decisions, relying on this case, have reached the same conclusion, that use of the subcontractor's bid does not constitute an acceptance.[4]

[4] Decisions in Idaho, Utah and Florida indicate that the courts in these states will follow the traditional common law rules in deciding a bid withdrawal case.

C. Promissory Estoppel

Perhaps because traditional common law principles did not serve the interests of the construction industry which is fundamentally reliant on the use of the telephone bid, the courts in many states have gradually rejected the common law approach in favor of promissory estoppel. Perhaps the best known example of the application of this theory to enforce a telephone bid is *Drennan v. Star Paving Co.*, a 1958 California case. There, the subcontractor submitted his bid to the contractor on the same day that the contractor's bid was submitted to the owner. The subcontractor was the lowest bidder for the paving work and the contractor used the subcontractor's bid. When the bids were opened, Drennan's bid was the lowest. Before Drennan was able to accept, he was told by the paving subcontractor that a mistake had been made in its bid and that it could not possibly do the work for the quoted price. When the paving subcontractor refused to perform, Drennan sued the subcontractor for damages.

The highest court in California held that under the traditional rules of offer and acceptance, there could be no contract. However, the court ruled that by the application of promissory estoppel, the subcontractor was bound by his bid because of the contractor's reliance on the bid when he included it in his bid to the owner. The court found that since the subcontractor's bid had not provided that it was revocable, and since the subcontractor should have foreseen that the contractor would rely on his bid, fairness demanded that the subcontractor be bound by the bid and either perform the contract or be liable for damages. Thus, promissory estoppel gave the act of reliance the status of a binding acceptance. Moreover, the theory put the burden on the subcontractor to inform the contractor that his bid was revocable if the subcontractor so intended.

D. Controlling the Risk of Bid Withdrawal

In dealing with the risk of bid withdrawal, it is essential that the contractor

know the law in his jurisdiction, that is, whether his courts follow common law principles or apply promissory estoppel.[5] The contractor should be familiar with the law because the notice he sends to the withdrawing subcontractor that the contractor intends to enforce the bid by suing for damages should reflect the principles recognized in that jurisdiction for enforcement of a telephone bid. For example, the contractor in a promissory estoppel jurisdiction, in replying to the subcontractor's attempted revocation of a telephone bid, should not refer in his letter to terms synonymous with offer and acceptance, but, instead, should use language indicative of his reliance on the bid in his bid to the owner. Likewise, contractors who are faced with the revocation of a telephone bid in a state that follows traditional common law rules should attempt to base their case on acceptance of the bid by some act other than use of the bid in quoting to the owner. A letter of intent, preparation of shop drawings and pulling a permit are a few of the acts which may be cited to demonstrate acceptance. Note, however, that in many cases, the mere listing of the subcontractor's name in a list of subcontractors provided to the owner does not provide the necessary acceptance to enforce the bid.

To avoid risk of bid withdrawal, the contractor should consider the following suggestions:

1. Verify a subcontractor's low bid if it is out of line with bids received from other subcontractors. Promissory estoppel requires that the contractor's reliance on the bid be “justifiable,” and if the bid is so low as to be suspicious, the courts might find that the contractor did not justifiably rely on the bid. This is particularly a problem in today's market where many unknown bidders are submitting very low bids.

2. Do not continue to negotiate after the bid is taken. Such negotiations may be

[5] Contractors who perform work in several jurisdictions should never assume that the law in all jurisdictions is similar.

construed by the court as evidence that the contractor did not rely on the bid, but continued to negotiate over the price, scope of work, etc. If negotiations are necessary, make it clear to the subcontractor that such negotiations are merely intended to iron-out non-essential items regarding performance.

3. Reduce negotiations to writing as soon as possible. If the low bid is taken over the telephone, and is used in the contractor's bid to the owner, the contractor should notify the low bidder of this fact in writing.

4. To minimize disputes regarding the terms of the bid, for example, scope of work, which addenda were quoted, etc., the contractor should routinely require the use of a bid proposal form. This form serves as an important document in proving that the bid was taken and its terms. It also helps to avoid the situation in which personnel taking a bid ask no more than whether the bid is "per plans and specs." This phrase may have a different meaning to different people. A sample bid proposal form follows:

BID PROPOSAL

JOB_____________________________DATE________________TIME__________am/pm TAKEN BY_______________

FIRM NAME____

BY____PHONE NUMBER_____________________________________

INSTALLED Yes____ No____ FOB JOB Yes____ No____

TAX INCLUDED Yes____ No____ AS PER PLANS & SPECS Yes____ No____

INCLUDING ADDENDA NUMBER:____

BID ON____

PRICE________________________ TAX________________________ TOTAL PRICE________________________

INCLUDES
EXCLUDES
NOTES

Good documentation of the bid and its components will not only assist the contractor in minimizing the risk of bid withdrawal, but also will assist the contractor in minimizing the risk of a default in the subcontractor's performance. Often, the reason for default is a disagreement over the scope of work, and good documentation at the time the bid is taken will help the contractor win such a dispute.

III. THE DEFAULTING SUBCONTRACTOR AND PAYMENT CLAIMS

A. Introduction

When a subcontractor defaults in the midst of performance, the contractor often is faced with payment claims arising out of the subcontractor's failure to pass on to his suppliers and sub-subcontractors their portions of the funds which he has received from the contractor. The contractor usually will be obligated to the owner to keep the job free of liens and claims. Claimants, however, are often well-versed in collecting payment through the mechanic's lien and bond statutes; hence the contractor faces the risk of having to pay twice.

The contractor's best weapons against this risk are (1) favorable subcontract provisions and (2) diligence during performance.

B. Favorable Subcontract Provisions

The contractor should remember that, in most cases, he has the leverage to insist upon subcontract language designed to protect him against the risks of subcontractor default. If the contractor does not assert this leverage by requiring favorable terms, he is not likely to have in his subcontract the language he needs when payment claims develop.

Listed below are suggested subcontract provisions which the contractor should insert in his standard-form subcontract to minimize the risk of non-payment:

1. The contractor should have the right to contact the subcontractor's suppliers and sub-subcontractors to confirm that payments are current. The provision granting this right should be worded so as to allow the contractor to make

inquiry of the subcontractor's payment history on all jobs involving a particular supplier. This is necessary because a payment problem may not have surfaced on the contractor's job, but might be discovered by speaking with the supplier regarding payments on other jobs.

2. The subcontract should require the subcontractor to identify all suppliers, materialmen and sub-subcontractors and the name of a person to contact at each company. The subcontractor also should be obligated to notify the contractor of a change in any of the companies listed. In those jurisdictions in which the lien law does not require a claimant to give notice of intention to file a lien before the lien is actually filed, the contractor may have no other way of learning about potential payment problems.

3. If possible, the subcontractor should be obligated to provide a payment bond. This is a must for large and unknown subcontractors.

4. The subcontract should contain a clause providing for non-assignment of the subcontract and subcontract proceeds such as progress payments. This clause should specifically address the possible existence of an accounts receivable financing arrangement which, upon default, could operate to the detriment of the contractor. Note, however, that the enforceability of a non-assignment clause varies from state-to-state.

5. Subcontract language should require the subcontractor to earmark all payments made to sub-subcontractors and suppliers by (a) identifying the project for which the payment is being made and (b) including language on the check which limits application of the payment to bills owed on the particular project. Otherwise, under traditional principles of law, the supplier is free to apply the payment to the oldest debt owed by the subcontractor regardless of the project.

6. The subcontract should require the subcontractor to furnish a release of liens and claims from suppliers and sub-subcontractors in consideration of receiving

progress payments.

7. The subcontract should require the subcontractor to incorporate by reference the provisions of the subcontract into his agreements with subsubcontractors and suppliers.

8. The subcontract should allow, at the discretion of the contractor, the use of joint checks. Specifically, the subcontractor should be required to agree in advance, upon signing of the subcontract, that (a) he will accept a joint check, (b) the joint check will provide no guarantee of payment to third-parties, and (c) he will accept the contractor's designation of the amount of the check to be allocated to his account versus the account of the joint payee.

9. The subcontract should expressly require the subcontractor to acknowledge that in submitting a requisition, he expects and intends the contractor to rely upon the information contained in requisition in paying the subcontractor. This provision also should make clear that the contractor is relying upon the subcontractor's representation that all suppliers, sub-subcontractors and others who have furnished labor or materials to the subcontractor for use on the project have been paid according to their payment requirements. Suitable requisition forms, releases, etc., should be used by the contractor to reinforce these subcontract requirements.

10. Subcontract language should provide that material and work covered by a partial payment requisition becomes the property of the contractor upon payment of the requisition, though this should not release the subcontractor from his responsibilities with respect to maintenance and protection of the work.

11. The subcontract should require a schedule of values for review and approval by the contractor at an early date in the project. The schedule of values should carefully be reviewed by the contractor to avoid “front-end loading.” Since the

schedule of values matter later assume importance in the event of the subcontractor's termination, for example, as a means of measuring the value of uncompleted work, it is important that the schedule of values be realistic.

Subcontract provision such as these are necessary to allow the contractor to monitor subcontractor payments to lower tiers and control the misappropriation of subcontract funds or the diversion of such funds to other parties, for example, lenders. These provisions are most helpful when they are used by the contractor in conjunction with diligent administration of the subcontract. Favorable subcontract provisions will be worthless as an aid to avoiding the risk of subcontractor payment claims if the rights extended to the contractor by such provisions are not implemented during performance. While this may subject the contractor to additional administrative costs (for example, personnel to monitor subcontractor payments), there is no better way to minimize the risk of payment claims.

C. Diligence During Performance

During performance of the subcontract, the contractor should do the following:

1. Insist upon properly-executed releases and waivers signed under oath by the subcontractor's principals. Do not use someone else's form waiver or release. Instead, tailor the documents to your needs and the requirements of your standard form subcontract.

2. Probably the most effective step you can take during performance to minimize the risk of supplier and sub-subcontractor claims is to monitor payments. Call suppliers at random, particularly suppliers who are known to be furnishing the more valuable items of equipment, to ensure that they are being paid. Do not merely ask them if they are being paid according to their “terms.” Their terms may require payment within 60 days and an acknowledgment that payment has been made according to their “terms” may not give you the information you

need to detect a problem. Ask them whether they are selling to the subcontractor on other projects and if so, whether payments on these projects are timely. When an inquiry is made to a supplier, document the date of the inquiry, the time, the person to whom you spoke, etc. The effective monitoring of subcontractor payments is particularly critical on public projects that are bonded, for the courts take an indulgent view of supplier compliance with the notice requirements contained in payment bonds.

3. Monitor material and equipment deliveries to the project to refute claims of timely notice under bond statutes. Again, the courts take a broad view of what may be included in a supplier payment bond claim: the contractor will have the burden of proof to demonstrate that the claim includes materials that were intended for another project or were never delivered to the project. If you do not know when deliveries are made, it will be difficult for you to sustain your burden of proof.

4. Beware of front-end loading in the subcontractor's schedule of values, progress schedule and monthly requisitions. If you permit the subcontractor to front-end the job, you are (a) reducing the subcontract funds available to complete the project; (b) providing the subcontractor's bonding company with a defense if the subcontractor defaults and you make a claim on the bond; (c) helping the subcontractor prove his delay claim against you; and (d) encouraging the subcontractor to abandon the work if he has gotten sufficiently ahead of you in payment so that he has no further incentive to perform, nor the money in his subcontract to complete.

5. Keep your eyes open for the signs of a subcontractor in trouble: phone calls not answered; insufficient manpower; calls from suppliers; notice of claims and liens; subcontractor employees looking for work; over-loaded requisitions; etc.

6. When using new and unknown subcontractors, subcontractors with known

payment problems, or subcontractors suspected to be in trouble, use the joint check arrangement which your subcontract allows. Ensure that in any discussion with suppliers who will be named as joint payees, you do not say anything to suggest that you are guaranteeing payment. Insofar as the supplier is concerned, the joint check arrangement should be confirmed by letter which delineates the scope of the arrangement and indicates that there are no terms regarding the arrangement other than those contained in the letter. When joint checks are issued, there should be a clear, written understanding on the part of all parties as to the payment to be allocated to each party.

7. In rare occasions, you may have opportunities to bring pressure upon the defaulting subcontractor's principals in order to convince them of the merit in their becoming personally involved in the problem. For example, many states provided for criminal prosecution of contractors and subcontractors who divert contract funds to other needs instead of paying creditors associated with the project. While prosecuting attorneys often are loathe to prosecute such acts, the facts and circumstances of a particular case may give you some leverage if you remind the subcontractor's principals of the existence of such statutes when you suggest they pay their suppliers. In many jurisdictions, another statutory requirement may also provide leverage. Most states require foreign corporations doing business in the state to register and qualify to do business as a foreign corporation. These statutes often provide for a severe penalty directly against the principals (officers, directors, agents, etc.) of the foreign corporation which does business without qualifying. For example, the statute may provide that the officer or director who has entered into the state in connection with company business will be personally liable for the breaches of contract and torts of the corporation. Such statutes, in effect ignore the corporate veil and impose liability directly on the individual.

These are merely some of the steps which prudent contractors should take during performance. When the contractor has negotiated the right to protect himself by subcontract provisions and follows-up by implementing his rights during performance, he has done all he can do to minimize the risk of payment claims associated with subcontractor default.

IV. THE DEFAULTING SUBCONTRACTOR AND PERFORMANCE CLAIMS

A. Introduction

In controlling the risks of subcontractor default in performance, you should proceed in the same manner as outlined above for controlling the risks associated with a default in payment, that is, subcontract provisions should be negotiated, and executed in the field, to minimize performance problems.

Once bidding is completed and the risk of a subcontractor withdrawing his bid has passed, the most significant performance-related problem that the contractor is likely to face is the possibility that the subcontractor will be unable to complete his work and must be either assisted or terminated. Further, occasionally, the defaulting subcontractor will assert a delay claim, or a claim alleging wrongful termination. In drafting subcontract provisions and monitoring subcontractor performance, the contractor should keep these potential risks and claims in mind.

B. Favorable Subcontract Provisions

Subcontract provisions that will assist the contractor in minimizing the risk of default in performance include the following:

1. A performance bond is probably the best insurance against subcontractor default, notwithstanding the delays which may occur in recovering the bond.
2. The subcontract termination clause should be drafted in favor of the contractor to provide for minimal written notice to the defaulted subcontractor. The acts which give rise to a default should be broadly defined. The law recognizes the concept of "anticipatory" breach of contract and the termination clause should

provide examples of such breaches: the contractor cannot always wait until the subcontractor's performance actually is due before he terminates the subcontractor.

3. The subcontract should provide for a “mark-up” or “administrative fee” or “liquidated damages” payable by the subcontractor to the contractor upon default. This fee is intended to compensate the contractor for the increased indirect cost which the contractor incurs when the subcontractor defaults and a replacement subcontractor must be retained and supervised. The amount of the mark-up, fee or damages should be expressed as a percentage of the costs incurred by the contractor to complete the work following the subcontractor's default, as opposed to a percentage of the “excess” cost of completing the work after deducting the remaining subcontract sum. The former method of computation will provide for a larger fee which more realistically reflects the costs incurred by the contractor in the event of a default, as opposed to a percentage of the “excess” cost of completing the work after deducting the remaining subcontract sum. The former method of computation will provide for a larger fee which more realistically reflects the costs incurred by the contractor in the event of default. Moreover, by express language, the contractor should be entitled to the fee whether the work is completed by the contractor's own forces or by a replacement subcontractor. Provisions such as this have been enforced against performance bond sureties.

4. Similarly, subcontract language should provide for the payment of attorneys' fees by the subcontractor resulting from the subcontractor's default. Often, upon the default of the subcontractor, the contractor will incur attorneys' fees for such things as advice as to how to handle the default, terminate the subcontractor, procure a new subcontractor or obtain materials purchased by the defaulted subcontractor but not delivered to the project, etc. In virtually all

jurisdictions, attorneys' fees are not recoverable unless they are provided for by contract or by statute. Hence, the subcontract should allow for the recovery of attorneys' fees. Again, there are decisions which have upheld the contractor's right to recover such fees from the performance bond surety on the basis of language in the subcontract.

5. The subcontract should allow the contractor to use the subcontractor's equipment upon default in order to mitigate the damages for which the subcontractor will be liable. Though this provision is rarely invoked, one can imagine situations in which all parties would benefit by allowing the contractor to use the terminated subcontractor's equipment; for example, where the masonry subcontractor has erected scaffolding prior to his default, it would be unnecessarily expensive to remove the scaffolding merely to allow the replacement subcontractor to erect his own scaffolding.

6. Recognizing the possibility that the contractor may be the target of a delay claim brought by the defaulted subcontractor, the subcontract should include a properly-worded "no damages for delay" clause. Again, as is the case with many other contract provisions, this clause should be based upon the law of your jurisdiction. An enforceable "no damages for delay" clause provides a good legal defense against a potential subcontractor delay claim.

7. The subcontract should require the subcontractor to present detailed cost data in support of any claims which he may have. In some jurisdictions, contractors may recover on the "total cost" theory of damages. By requiring the subcontractor to prove the individual elements of his claim, the contractor may be able to prevent use of the total cost theory.

8. The remedies clause in the subcontract should reflect the remedies clause of the prime contract; in no event should the subcontract grant a greater remedy to the subcontractor than the contractor enjoys in the prime contract. This is

important if the subcontractor's claim of delay or for extras is ultimately attributable to acts for which the owner is responsible.

9. The subcontract should provide that if the subcontractor is wrongfully terminated, his damages for wrongful termination shall be limited to the value of work performed, but not paid for, as of the date of termination. In no event should the subcontractor be entitled to recover anticipated profit upon unperformed work. Further, if there is a termination for convenience clause in the subcontract, the subcontract should stipulate that a wrongful termination will be deemed a termination of convenience.

10. The subcontract should contain a clause obligating the subcontractor to indemnify the contractor in the event the contractor incurs costs arising out of or relating to the subcontractor's work. Such costs might result from warranty claims, claims for defective work, attorneys' fees in defending against third-party (e.g., owner) claims relating to the subcontractor's work, etc.

C. Diligence During Performance

Armed with subcontract provisions such as these, the contractor is equipped to minimize the risk of subcontractor default in performance and successfully defend against subcontractor claims. To supplement the protection afforded by his subcontract, the contractor should follow these practices during performance:

1. As a general rule, it is probably cheaper in the long run to nurse the subcontractor than to terminate his performance and replace him. Therefore, the contractor should avoid the temptation to take a hard line against the failing subcontractor where there is a possibility of assisting him to complete his work. This advice, however, should be tempered by the recognition that there often is a fine line between reserving the right to terminate a subcontractor for default and the waiver of this right by conduct suggesting that the default in performance is acceptable. The contractor who elects to help the subcontractor

complete his work should continually be aware of, and attempt to minimize, the risk that his efforts will be deemed by a court to amount to a waiver of the right to terminate.

2. The contractor who helps a troubled subcontractor complete his work should keep in mind the following:

   a. The trouble which the subcontractor is facing may be attributable to the owner; for example, the subcontractor's performance may have been disrupted and made more costly by errors in the contract documents. If the subcontractor can prove to the contractor's satisfaction that his performance is suffering as a result of acts or omissions attributable to the owner, the subcontractor probably deserves help because (1) he is not responsible, ultimately, for his problems and (2) there may be an opportunity to recover his losses and the contractor's losses from the owner.

   b. There may be no realistic alternative to helping the subcontractor in trouble. Due to time constraints or the unique nature of the subcontractor's work, the contractor may find that there is no replacement subcontractor to complete the work, or complete it on schedule.

   c. The contractor assisting the subcontractor in trouble can at least control the remainder of the subcontractor's work and help him keep down his costs.

   d. Arrangements should be made with the subcontractor to ensure the recovery of the contractor's increased costs resulting from the default, for example, by means of a liquidation and consolidated claim agreement, if the problem is ultimately attributable to the owner.

   e. The contractor should consider a special payroll account as one of the

procedures created to assist the troubled subcontractor. Such an arrangement allows the contractor to control the disbursement of funds advanced to the subcontractor and to carefully monitor the increased costs of performance resulting from the default.

3. <u>If the subcontractor has a performance bond</u>, special considerations apply:

   a. The bonding company should be notified of the default immediately and should be urged to become involved in improving the subcontractor's performance as soon as possible. A prudent bond attorney or claims agent will recognize the value of cooperating to help the subcontractor complete his work versus the costs that will be incurred in defending against the contractor's claim against the performance bond.

   b. The contractor must obtain the bonding company's agreement to such emergency measures undertaken on the subcontractor's behalf as payroll advances, reducing retention, placing the subcontractor's employees on the contractor's payroll, involving the contractor's employees in the subcontractor's management, waiver of claims, etc. Otherwise, the bonding company may have defenses against the contractor's performance bond claim.

   c. Virtually all performance bonds contain requirements that (1) notice of a default be given to the bonding company, and (2) suit to enforce the bonding company's obligations be filed within a stipulated time. The contractor should become familiar with these requirements and ensure that timely notice is given and that suit is filed, if necessary, before the statute of limitations expires. Even where the bonding company is cooperating to resolve the problem, the deadline for filing suit may expire before the project is completed, and the contractor should ensure

that the deadline does not pass without either final settlement of his claim or filing suit.

4. If, based upon the contractor's appraisal of the entire situation surrounding the subcontractor's default, the contractor concludes that the subcontractor cannot be nursed to completion, but must be terminated and replaced, the contractor should do the following:

   a. The contractor must strictly comply with the termination clause of the subcontract, particularly notice requirements. Termination of a subcontract amounts to a forfeiture which the courts abhor; therefore, they carefully and strictly scrutinize the termination to ensure that the contractor acted in compliance with subcontract provisions. For example, if the subcontract calls for written notice of termination to be delivered to the subcontractor in a stipulated amount of time and by a stipulated method (for example, registered mail), then the contractor's notice must comply with these requirements.

   b. If the contractor believes there may be a waiver problem, it should be addressed in his notice. Otherwise, he may expose himself to the subcontractor's claim for wrongful termination.

   c. Again, notice to the subcontractor's performance bond surety, if any, is essential and must be timely.

   d. The contractor must keep good, accurate records of the costs he incurs due to the subcontractor's default and termination. Such records should establish the following:

      (1) The records should demonstrate the administrative costs, as well as the costs of labor, equipment and materials, incurred by the contractor due to the default. If the contractor does not have routine records systems for recording administrative time, such

systems should be created to record the time expended by management personnel in connection with a subcontractor default.

(2) Monies paid to other subcontractors brought in to complete the terminated subcontractor's work should be recorded.

(3) The contractor should anticipate, and be prepared to refute, the claim that he has "gold plated" the cost of completing the work. The contractor will not be permitted to recover from the terminated subcontractor (or his bonding company) damages deemed by the courts to be unreasonable.

(4) The contractor should have a survey of the remaining work performed upon termination to estimate the cost to complete the work before this begins.

(5) The contractor should attempt to obtain at least three bids for completion of the remaining work, including a bid from a subcontractor recommended by the terminated subcontractor's performance bond surety.

(6) If the subcontractor's default has delayed the project and the contractor attempts to overcome the delay by working on an accelerated basis, the contractor's records should reflect the costs incurred as a result of acceleration separately from the costs incurred merely to complete the subcontractor's work; that is, the premium associated with acceleration should be identifiable on the basis of the contractor's cost records.

e. Contact the subcontractor's suppliers to purchase directly from them the materials you need which may already have been fabricated for the project or reserved for delivery to the project. Recognize, however, that

suppliers may want to be paid for funds owed them before they release the materials.

f. If circumstances dictate and your subcontract permits, use the subcontractor's equipment to complete his work.

g. If the terminated subcontractor is bonded, respond promptly and accurately to the status inquiries sent to you by his surety. Inaccurate or untimely responses may be cited by the surety as a basis for estopping you from pursuing your performance bond claim.

h. Be sure to require a replacement subcontractor to provide you with a new warranty for the work he performs.

i. Upon terminating a subcontractor, confirm through your notice of termination that he has no claims against you and that you are not responsible for his default. Keep in mind the possibility that he may later assert a delay claim and/or claim a wrongful termination which you should anticipate in your notice of termination.

j. If the terminated subcontractor has a performance bond, you must decide whether you will call upon the surety to complete his work, or will complete the work yourself and then seek recovery from the surety. There are a number of factors to consider in making this decision:

  (1) The surety's interest is merely to complete its principal's work at the lowest possible cost. This, however, may not be consistent with your interests. Hence, completing the work yourself with your own forces or by hiring a replacement subcontractor, may give you greater control in scheduling the remainder of the project, selecting a replacement subcontractor, etc.

  (2) As a result of the subcontractor's default, the contractor may

have claims for administrative costs incurred due to the default, attorneys' fees, and other damages not directly related to the cost of completing the work. If the defaulted subcontractor is insolvent but bonded, the contractor may wish to assert these claims against the performance bond surety. The contractor may have a better chance of recovering these costs from the surety if he completes the work, rather than the surety. Further, at least one case suggests that where the work is completed with the contractor's own forces, instead of by a replacement subcontractor, the contractor has a better claim to the recovery of an administrative fee.

(3) A countervailing consideration is the question of cash flow. Where the surety undertakes to perform, the contractor will not be required to advance monies to complete the work and then await reimbursement by the surety.

V. SPECIFIC PERFORMANCE

Specific performance is an equitable remedy applicable to contracts. The purpose of the remedy is to give to the non-breaching party the benefit of his contract by compelling the other party to do that which he has agreed to do, perform the contract. Thus, the aim of a request that a contract be specifically enforced is to obtain a court order directing the other party to perform.

The traditional rule is that specific performance of construction contracts will not be granted. This is because such contracts ordinarily require the performance of personal services. The courts will not compel the performance of personal services because they deem themselves to be incapable of superintending performance and because the party claiming a breach usually has an adequate remedy at law, that is, damages.

Since construction contracts normally involve the performance of personal services (for example, furnishing labor to install materials or furnishing labor to fabricate materials), construction contracts usually are not specifically enforceable. This is especially true where performance of the contract will extend over a considerable period of time and will include a series of acts of a protracted, complicated or specialized nature.

There are, however, certain exceptions to the rule which, in unique circumstances, might enable a contractor to obtain a court order directing the nonperforming subcontractor to perform. Such cases often will depend upon the inadequacy of the remedy at law, i.e., money damages for breach of contract will not put the contractor in the position in which he would have been had the contract been performed. In one case from Oregon, where the construction work remaining to be done was simple and the details of the project were recited in the contract with sufficient clarity, specific performance was ordered by the court. In another case, which exemplifies the problems which a contractor often faces upon the default of a subcontractor in the middle of performance, the court ordered specific performance of the contract where it appeared that the defaulting subcontractor was required to furnish stone of a particular kind and texture and the subcontractor was the only source for the stone. Moreover, at the time of the default, enough stone had been furnished to complete two-thirds of the structure so that if the subcontractor was not required to furnish the remainder of the stone, it would be necessary to use other stone and thus destroy the harmony and beauty of the building, or tear it down and rebuild it with other materials.

In *Grayson-Robinson Stores, Inc. v. Iris Constr. Corp.*, the New York Court of Appeals rejected the traditional argument that specific performance of a building contract is never ordered because of the necessity of continuous judicial supervision and control of such performance. The court stated that there was no hard-and-fast rule against applying the remedy of specific performance to such contracts, especially where the parties have by agreement provided for just that remedy. The court further indicated that the modern trend is towards specific performance and that there is clearly no binding rule preventing a court from ordering

specific performance of a building contract.

Therefore, in those rare circumstances where the contractor can demonstrate that the defaulting subcontractor agreed to specific performance in the subcontract and that the contractor has no adequate remedy at law due to the unique nature of the work to be performed by the subcontractor, a court of equity may well entertain a request for specific performance.

VI. BANKRUPTCY AND THE DEFAULTING SUBCONTRACTOR

In both Chapter 7 liquidations and Chapter 11 reorganizations, the filing of a petition in bankruptcy creates an estate. 11 U.S.C. § 541. The property of the estate includes all of the property of the debtor as of the time of the filing of bankruptcy. Section 541(a)(1) provides that property of the estate includes "all legal or equitable interests of the debtor in the property as of the commencement of the case." In states where payments to a contractor or subcontractor are found to be impressed with a trust for unpaid material and labor claims, the unpaid claimants argue that these funds are not "property of the estate" for purposes of § 541. In this way, they are generally unavailable to the trustee to pay claims of other unsecured creditors.

The bankruptcy statute indirectly comes to the aid of the contractor who has made payments to a defaulting subcontractor in another way. The trustee is able to bring back into a bankrupt subcontractor's estate transfers made within 90 days of bankruptcy. The trustee can exercise his avoidance powers over such transfers (often referred to as "preferential transfers") if he can establish that (1) a transfer of property of the debtor (2) was made to or for the benefit of a creditor (3) on account of an antecedent debt (4) while the debtor was insolvent and (5) the transfer was made within 90 days before the date of filing of the bankruptcy petition. 11 U.S.C. § 547. This section indirectly operates to the benefit of the contractor if there is a statutory trust applied to the payments a subcontractor makes to his materialmen and suppliers. If such a trust is established, the payments that a subcontractor makes to his suppliers are not considered property of the debtor's estate. Thus, the trustee in

bankruptcy is not able to direct that these payments be returned to the debtor. By allowing the suppliers to keep payments made on the eve of the subcontractor's bankruptcy, the contractor's liability for lien and bond claims is limited.

In *Schneider Fuel & Supply Co. v. West Allis State Bank*, (1975) the Wisconsin court held that a bank became a statutory trustee for funds due materialmen on a public project. The Wisconsin statute provides that proceeds paid to a contractor or a subcontractor constitute a trust fund in the hands of the contractor or subcontractor for claims due or owing for labor and materials. The bank as assignee of the proceeds argued that it was not a statutory trustee because the money was not in the hands of the contractor. The court rejected this argument stating that the bank knew the proceeds of the check originated from a public project.

While the trustee can avoid preferential transfers made within 90 days of bankruptcy, § 547 (c) of the Bankruptcy Act lists exceptions to the trustee's avoidance powers. Section 547(c)(2) precludes the trustee from avoiding payments of debts incurred in the ordinary course of the debtor's business. These payments are exempt from preference status if they have been made no later than 45 days after such debt was incurred and made according to ordinary business terms. This provision can aid a contractor whose subcontractor declares bankruptcy in that the payments made by a subcontractor remain in the hands of his suppliers. The contractor and surety will not be responsible for the amounts thus paid even by means of a mechanic's lien or bond claim. However, the courts strictly construe the date that a debt was incurred.

In a 1982 Kentucky case, *Bryant v. General Finance Co*., the trustee asserted that installment payments on a note constituted a preferential transfer of the debtor's property. The creditor contended that the payments were made in the ordinary course of business and were not avoidable by the trustee. The court found that the payments were a preferential transfer because the debt was incurred at the time the debtor received the full consideration. In this instance the loan had been made approximately one year before the bankruptcy. Therefore, the payments were recoverable by the trustee.

In the context of credit card debts, debts are deemed to have been incurred when the debtor obtained a property interest in the item purchased rather than when the invoice was sent. *In Re Browne*, a 1982 New York case, has particular applicability in the construction industry. Suppliers who grant open accounts to subcontractors usually bill on a monthly basis. In order to defeat the trustee in a contest for the proceeds of a payment, the materials must have been purchased within 45 days of payment. Thus, a contractor may find himself paying for materials that were invoiced and paid by the contractor more than 45 days after their receipt by the debtor subcontractor.

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