

ISSUE
HIGHLIGHTS

Articles

- 1 **Contractor and Surety: Till Death Do Us Part**
- 6 **Mechanics' Liens – An International Perspective**
- 9 **A Little Corporate Housekeeping Can Help Avoid a Big Mess**
- 10 **An Alternative to Performance Bonds – Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor**

Casenotes

- 5 **Florida Supreme Court to Rule on Bad-Faith Claims Against Sureties**
Dadeland Depot, Inc. v. St. Paul Fire and Marine Ins., Co. (2004)
- 8 **Subcontractor's Knowledge of Project Conditions Bars Delay Claims**
Metropolitan Steel Industries, Inc. v. Perini Corp. (2004)
- 12 **New Jersey Upholds Pre-Work Notice Requirement for Public Payment Bond Claims**
Dial Block Company, Inc. v. Mastro Masonry Contractors (2004)

Alert

- 5 **New York Lien Law Amended**

Contractor and Surety: Till Death Do Us Part

The well-publicized contraction of the surety market, resulting

from aggressive surety underwriting in the late 1990s, the general economic dip in the early 2000s and the post-9/11 insurance industry crunch, has refocused industry attention on surety bonds, principally because bonds

are increasingly difficult to procure.

While most participants in the construction industry have some experience with bonds, there is widespread confusion, even among the most experienced players, regarding the types of bonds that are available, how bonds and sureties function, the remarkable power contractors give to sureties (often unknowingly), and about the differences between insurance and surety bonds.

A frequently overlooked aspect of a contractor's relationship with its surety company is the General Agreement of Indemnity (GAI) — overlooked that is, until the bond is called on and the surety starts dipping into the contractor's corporate assets, and possibly the personal assets of the owners and their families, to recoup losses. Only then do contractors get a crash course on the commitments that they have made, and learn that there is no divorcing their surety.

While the particulars of how bonds, GAIs and contractors' relationships with their bonding companies will vary from state to state, from bond form to bond form and from GAI to GAI, some general principles apply fairly uniformly across the board. This article will give those unfamiliar with bonding a general overview of basic bonding principles — with a special emphasis on the broad rights and

powers that contractors frequently give to their sureties through the GAI: the bonding pre-nuptial agreement.

Bonds – What They Are and Why You Need Them

Construction projects are high-risk endeavors. They are complex projects, unique from one to the next, performed by competitive bidders motivated to cut their risk-reward ratio very close in order to secure the contract. Sophisticated owners know that a contractor's performance can be affected by a wide variety of factors, only some of which are truly within the contractor's control. The owner, too, shares in this risk. If its contractor fails to perform, an owner is exposed to increased costs of completion, costs of delayed completion, potential breaches of its commitments to lenders, investors and customers, costs of renting cover facilities, and/or lost rents and profits from the uncompleted project. Additionally, when a contractor defaults, an owner must now go to the marketplace and hire a replacement contractor, often under critical time constraints that preclude the full economic benefit of competitive bidding. The owner also bears the risk that liens will be filed against its project by unpaid subcontractors and suppliers. These liens may expose the owner to liability for payment and their clouding the





owner's title may be a breach of the owner's obligations to its lenders.

Most public and many private owners seek to transfer these inherent risks to a surety, by requiring their contractors to post the most frequently encountered bonds — performance and payment bonds. Performance bonds are a surety's guaranty that it will stand behind a contractor's obligations to perform under its contract; payment bonds are a surety's guaranty that a contractor will honor its obligations to pay its subcontractors and suppliers. They are routinely procured simultaneously for one premium, typically between 1 and 3 percent of the "penal sum," the maximum value of the surety's guarantee (absent extraordinary circumstances), usually equal to the value of the bonded contract.

Thus, the short answer to why contractors need to post bonds is simply that many owners, public and private, absolutely require them.

Dispelling the Primary Misconception – Surety Bonds Are Not Insurance Policies

Because most surety bonds are issued by insurance companies (since they have the sufficient financial wherewithal to make owners comfortable that they can back up a promise with cash), bonds are often confused with insurance products. Bonds are not in-

surance; on the contrary, they are additional risks that contractors take on. They are not risk management tools for the bonded contractor — they are risk management tools for the owner.

An example will illustrate the difference. A liability insurance carrier normally does not look to its insured for repayment if the insurer has to pay out on a claim. Thus, if a contractor is sued due to a job site personal injury and its insurer settles the claim, the contractor's commercial general liability carrier does not seek reimbursement from the contractor for the loss.

If the contractor does not have the funds, the surety is likely going to look to the contractor's principals personally.

The same is not true for a bond loss. The bonded contractor did not pay the bond premium to protect itself from the risk that it would default on its contract obligations. As discussed above, the contractor procured the bond to meet the owner's requirement that the contractor provide the owner with additional security that the contractor would honor its contractual performance and payment obligations. Thus, if the surety has to step up and make good on its promise to back up a contractor's bonded perfor-

mance or payment obligations, the surety is going to seek to recover from the contractor every penny that the surety incurs in meeting the contractor's obligations. Thus, posting a surety bond is similar to posting a bank letter of credit — it is not insurance that protects a contractor from its own defaults. (See article, *An Alternative to Performance Bonds*, on page 10.)

Moreover, if the contractor does not have the funds, the surety is likely going to look to the contractor's principals personally — to their personal bank accounts, to their personal investments, possibly even to the equity in their homes.

Your Prenuptial Agreement – the GAI

Unless a construction company is among the biggest and best capitalized, a surety will not issue bonds on the company's behalf unless the surety receives indemnity agreements from the company itself, its principals and possibly other indemnitors, such as principals spouses (collectively, the Indemnitors), with enough collective assets to satisfy the surety that if it has to pay out on the bonds, it will be able to recoup its losses. It cannot be overemphasized that the surety's perspective on its bonds is that they should be risk-free to the surety — the surety should, in theory, never lose money when it writes a bond. In the ideal world of suretyship, it should collect its premium and have enough protection from the Indemnitors and that it should be able to recoup whatever it expends in meeting its bond obligations. The surety bond market contraction is, at least in part, a product of sureties'

lack of vigilance in these underwriting procedures and the resulting unreimbursed, sometimes catastrophic, losses.

While there are a variety of similar common law (noncontract-based) rights that a surety may have to recover its losses even without a GAI, sureties routinely have the Indemnitors sign a very broad GAI, which gives the surety even greater powers. Normally, a blanket GAI is signed at the outset of a contractor's relationship with a bonding company, which will apply to

ILLUSTRATIONS: LIAM ROBERTS

all bonds thereafter issued.

While GAI forms vary, they typically give the surety the following rights: (1) the right to seek complete indemnification from the Indemnitors for all costs, damages and expenses that the surety may incur as a result of a bond claim; (2) the right to demand that the contractor and/or the Indemnitors pay claims against the bond in the first instance, so the surety does not have to; (3) the ability to demand that the Indemnitors post a cash collateral “reserve” to ensure that if the surety is required to pay a bond claim, it has the Indemnitors’ cash on hand to make itself whole and will not have to chase down the Indemnitors after the fact; (4) the right to settle bond claims in its sole discretion and to seek indemnity from the Indemnitors even if the Indemnitors disputed the claim against the bond and/or dispute the manner in which the surety settled the claim; (5) the ability to demand financial information from the Indemnitors, to examine their books and records, and to request financial information from the Indemnitors’ banks, credit agencies, etc.; and (6) the right to refuse to issue any additional bonds at any time.

GAIs also give sureties the ability to take over bonded projects if the surety determines that doing so would either avoid a default or mitigate the damages from a default. The GAI usually has provisions that give the surety the rights (but not the obligations): (1) to take over the contractor’s bonded contract using the contractor’s resources; (2) to negotiate settlements with the owner; (3) to agree to changes in the contract with the owner; (4) to make loans or advances to the contractor or others for what the surety judges to be the benefit of the bonded contract; and (5) to require that all funds due to the contractor on a bonded contract be paid to the surety instead of the contractor.

And, of course, the surety will seek to have all costs it incurs reimbursed by the Indemnitors — this is a primary point of tension between sureties and their contractor customers.

What Happens When a Contractor’s Performance or Payment Bond Is Called On

When the surety receives notice of a payment bond claim, it typically embarks upon a number of simultaneous inquiries to explore the legitimacy of the claim, any disputes regarding the claim and to determine whether contractual or bond de-

fenses exist. Payment bond forms typically have limits on how many tiers of subcontractors may make a claim on the bond, how long rights to claim against the bond survive and particular notice requirements — all of which may differ from form to form and any of which may serve to form the basis of a surety claim defense.

The surety will routinely ask the claimant for detailed information regarding the claim, such as the applicable contract, documents that substantiate the claim, information regarding when the claimed work was performed and when the claimed payment was due, payment applications, among other information. The surety will also usually ask the bonded contractor for its position on the claim, i.e., is the claim admitted or disputed and, if so, the nature of the dispute. The surety needs this information so that it may assess both the claimant’s position and the bonded contractor’s position, as the surety has

The surety has obligations to both (the bonded contractor and the claimant) that may be in conflict...

obligations to both of them that may be in conflict — it is obligated to pay the proper claims of claimants, but it is also obligated to the bonded contractor not to pay if the claim is not proper, as it may lose its rights to reimbursement from the bonded contractor if it wrongly pays a claim. For example, the bonded contractor may respond that the subcontractor’s claim is invalid because it did not perform its work and, thus, the bonded contractor contends not only that no sums are due to it, but that the bonded contractor has a claim against its subcontractor. This type of conflict, if a seemingly legitimate dispute, may throw the surety into a quandary: to pay or not to pay?

If the surety’s investigation reveals that the sums are properly due and owing to the claimant, and that no defenses exist to payment, the surety will typically seek to have the bonded contractor pay the claim directly. If the bonded contractor fails to pay the claim, but offers no basis for a defense to the claim, the surety may pay the claim itself and seek indemnity from the bonded contractor. If the bonded contractor maintains that defenses exist to the claim, the surety may deny the claim but seek an

additional confirmation from its bonded contractor that if the claimant sues on the payment bond, that the bonded contractor will defend and indemnify the surety from the lawsuit.

Performance bond claims are frequently far more complicated to assess. Typically, the performance bond surety’s obligations are tied to the “default” of the bonded contractor. Bond forms vary widely in their triggering events, and some require not just a “default,” but a “default and a declaration of default,” by the owner, while others may require a default and actual termination of the contractor’s employment under the bonded contract by the owner. Others may permit partial defaults and partial terminations — it all depends upon the particular bond form and the terms of the bonded contract, which will be read together in assessing the parties’ rights and obligations.

When a performance bond surety

receives an owner’s notice of a claim, it usually acknowledges receipt of the notice, reserves all of its rights and defenses, and embarks upon an investigation. Again, the surety has obligations to multiple parties that may be, and frequently are, in tension. It owes its contractor/principal the obligation not to honor improper claims, and it owes the claimant the duty of honoring its proper claims. The surety must typically conduct its investigation and make a determination of how it intends to proceed either within the time period stated in the applicable bond, or in a “reasonable” period of time if none is stated. Of course, what is “reasonable” in a given context is open to much debate and is a ripe area for litigation.

Under the pressures of a halted project, an owner demanding that the surety promptly honor its obligations, and with the contractor denying that it defaulted or arguing that its default should be excused by an owner’s non-payment, a surety must make some difficult decisions. If its investigation leads it to conclusion that the bonded contractor was not in default, or that the obligations under its bond were not properly triggered, the surety may opt to simply sit on its rights and deny the owner’s claim

on the bond. It then leaves the owner to fend for itself in completing the project.

In so doing, however, the surety leaves itself exposed to the likelihood of litigation with the owner. Wrongly selecting the sit-on-its-rights option also potentially subjects the surety to increased exposure. If a court determines that the surety wrongfully failed to honor its obligations, it may be exposed to damages in excess of the penal sum of its bond (a potentially unlimited risk). (See *casenote, Bad-Faith Claims Against Sureties* on page 5.) Further, by allowing the owner to complete, the surety loses the ability to limit its exposure by controlling the manner in which the project is completed, and loses a chance to negotiate

to take over and complete the project immediately.

Contractors threatened with default often seek to have their sureties assist in funding their own completion of the contract work, as this may avoid a default and termination. Typically, the surety will only finance the bonded contractor's completion if the surety determines that doing so will cure a solely cash flow-induced default on a project that it believes will ultimately be profitable if completed by the bonded contractor.

Owners usually prefer to have the surety take over and complete the project. This option is often the cleanest for the owner, but poses substantial exposure for the surety, as some jurisdic-

spending, and should generally be proactive in its efforts to contain the surety and its expenditures. By doing so, the contractor may limit the surety's expenditures and can begin to make a useful record for defending the inevitable effort by the surety to seek indemnity.

Like a Good Marriage – It's Not All Bad

Your relationship with your surety is not all downside, though. First and foremost, contractors get the primary benefit they seek from sureties — the ability to secure a contract where a bond is required. Also, sureties often have great resources that they can, at their discretion, bring to bear to assist a struggling contractor on a bonded job. Sureties may make financial advances to prop up contractors that are having cash flow problems. Sureties can get involved before a default to work with the contractor and/or the owner to prevent defaults. With a contractor's agreement, a surety can even take over part of a bonded contract to diminish the administrative and resource burden on an overextended contractor. Sureties also often have a variety of resources to prop up a struggling contractor, such as expert consultants, accountants and lawyers.

Again, the surety will typically expect to be completely reimbursed for the costs incurred in providing assistance to its contractors. These costs incurred in getting the job done, however, may be lower than the costs that would be incurred should a contractor be defaulted and terminated.

Read Your Pre-Nup Before You Sign

This very general overview of surety-contractor relationships should give contractors insight into what they are committing to when they walk down the aisle with their surety. Like a marriage, this is a long-term, complex relationship with many pros and cons, and potential risks and potential rewards. But, remember, every surety's contracts, every surety's bonds and every surety's GAIs are different. As with every other contract, they should be read and their risks and benefits understood before they are signed. Once signed, and once the surety posts bonds for the contractor, it is bound to that surety, at least for the life of the bonded contracts—and likely beyond. ■

The surety often tries to limit its risk in the takeover scenario by attempting to negotiate a "takeover agreement" with the owner, which limits the surety's exposure.

a favorable up-front cash settlement with the owner.

Alternatively, if the surety concludes that its bonded contractor was in default and that its bond obligations have been properly triggered, and the surety decides to do something, it has a wide variety of "somethings" to choose from. The surety may (1) finance the bonded contractor's completion of the contract; (2) takeover the performance of the contract by hiring a new completion contractor; (3) tender a new contractor to the owner for the owner to contract with for completion (while agreeing to pay completion costs in excess of the bonded contractor's remaining contract balance); (4) offer a straight cash settlement to the owner in exchange for a release; (5) reserve its rights to contest the default at a later date and enter into a takeover agreement with the owner while agreeing to fund the completion in the first instance, once the available contract balance is exhausted by the owner; (6) or embark upon any creative type of negotiated resolution of the matter with the owner that is mutually agreeable to the owner and the surety. All of these options have risks and benefits to the surety — options it must weigh while naturally being pressured by the owner

dictions dictate that in so doing, the surety has committed to complete the bonded contract regardless of cost. The surety often tries to limit its risk in the takeover scenario by attempting to negotiate a "takeover agreement" with the owner, which limits the surety's exposure. The surety may also favor tendering to the owner a new contractor for completion, whose obligations are guaranteed by another surety's performance bond. By doing so, the surety limits its exposure to the difference between the available contract balance and the price of the new contractor (which often is competitively bidding for the completion work with a surety with substantial bargaining power).

Whatever course the surety takes, it must always be mindful that when the time comes for it to seek indemnity for its costs from the bonded contractor and/or other indemnitees, they will likely be scrutinizing every act by the surety for defenses to the surety's claim. Thus, the defaulted bonded contractor should not simply step back and permit the surety to take whatever course it chooses. The contractor should be active in monitoring the surety's completion efforts, should provide written notices of warning to the surety if the contractor believes the surety is over-

Florida Supreme Court to Rule on Bad-Faith Claims Against Sureties

Dadeland Depot, Inc. v. St. Paul Fire and Marine Ins., Co. (2004)

A shopping center project in Miami, Dadeland Station, was completed, opened and leased to commercial tenants in November 1996. However, shortly thereafter, the shopping center owner discovered construction and engineering defects. In addition, Metropolitan Dade County building officials found a number of violations of the South Florida Building Code. The owner demanded that the general contractor correct the defects and notified the contractor's performance bond sureties, St. Paul Fire and Marine Insurance Co. and American Home Insurance Company (the Sureties). The Sureties had issued a standard performance bond in the amount of \$26,000,000.

The original general contractor and the Sureties failed to correct the defects to the owner's satisfaction, and the owner initiated an arbitration proceeding against them. The owner sought damages for repair expenditures, security, legal fees, engineering fees and administrative costs. The owner later declared the contractor in default and demanded that the sureties take action to correct the general contractor's mistakes.

The arbitration panel awarded the owner damages against the general contractor for defective work, but did not award any costs or attorney's fees. Subsequently, the owner filed a lawsuit against the Sureties in Florida state court, charging that the Sureties had engaged in bad-faith refusal to perform their duties under the performance bond.

The Sureties removed the action to the federal district court. The owner's claim was based on a Florida statute that allows recovery of attorney's fees and costs as a result of an insurer's refusal to settle a valid claim. The federal district court dismissed the claims — and the owner appealed.

The Court of Appeals reviewed the issues and determined that this was a

unique question of Florida state law that should be first ruled on by the Florida Supreme Court. Therefore, the Court of Appeals certified the following question for the Supreme Court to answer:

► Does the Florida statute allowing bad-faith claims against insurers apply to an owner's claim against a contractor's performance bond surety?

The Florida's Supreme Court's decision is expected within the next few months. ■

Editor's Note

► In the event that the Florida Supreme Court answers affirmatively, this will likely result in judgments against sureties that exceed the penal sums of the bonds. This situation, though not unprecedented in other jurisdictions, is somewhat unusual. However, the Florida statute presents a ready-made vehicle to assess additional costs against sureties that delay the payment of valid claims. This could ultimately lead to increased bond premiums as well as an increase in the amount of collateral required to be posted by bond principles. The implications to Florida's construction industry cannot be overstated.

«ALERT» NEW YORK LIEN LAW AMENDED

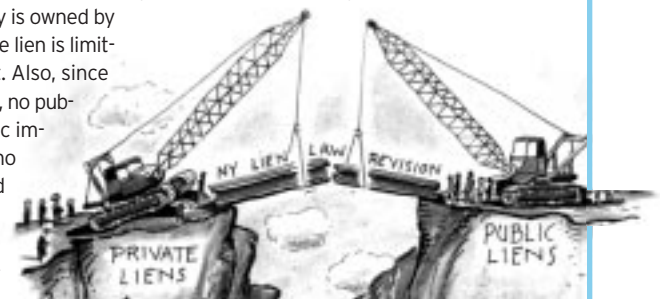
On July 20, 2004, effective November 18, 2004, the New York Lien Law was amended to plug a gap in the rights provided to contractors. The amendment to Section 5 (public improvement liens) addresses a particular type of private/public construction project where the existing law did not provide lien rights or payment bond protection for the contractors, subcontractors, materialmen and workers who had provided work, labor, services or furnished materials for the improvement. On a purely private or a purely public project such persons or entities had payment protection by the rights afforded them under the Lien Law. However, hybrid private/public projects fell through a gap in the Lien Law and no similar protections were afforded.

The prime example is where a private entity leases property from the State, City or public corporation, and then constructs the building or fa-

cility on this property for the benefit of the private entity. Examples include the many recent airline terminal projects at JFK International Airport where the airlines lease the terminals from the Port Authority, which holds a lease from the City of New York, which owns the land. The Court of Appeals, New York's highest court, has held that such property is immune from mechanics' liens because the underlying real property is owned by a public entity. This is true even if the lien is limited to the private leasehold interest. Also, since the improvement is a private venture, no public fund exists against which a public improvement lien could be filed. Thus, no Lien Law protections were afforded to those benefiting the property.

The Lien Law amendment provides that for projects, with an esti-

mated cost in excess of \$250,000, the public owner shall require the private developer to post a bond or other undertaking guaranteeing prompt payment to the contractor, subcontractors and all parties supplying labor or materials to the project. This provides a measure of protection against nonpayment and thus ameliorates to some degree their lack of lien rights.



Mechanics' Liens — An International Perspective

One of the most important concerns for any contractor is

receipt of payment. Wherever construction contractors seek opportunities, it is critical that they carefully investigate and understand their rights in the event of nonpayment. This investigation must start in the pre-bidding phase of a project. Although various legislatures in the United States have

assisted contractors and suppliers in dealing with the risk of nonpayment by enacting what are commonly called mechanics' lien laws, such statutory protections generally do not exist elsewhere. Even in the United States, the substantive protections afforded by these laws often vary dramatically from state to state. As a result, U.S. contractors performing work outside of the U.S. must typically pursue other means to ensure payment, and non-U.S. contractors performing work within the U.S. need to be aware of these laws to fully understand their payment rights and remedies.

Mechanics' Liens in the United States

In each of the states, there is presently some form of mechanics' lien law, but there is no uniform statute across the nation.¹ Notwithstanding, there are some common themes, and for the non-U.S. contractor, the following is a brief explanation of how such laws generally operate.²

In the context of private improvement projects, mechanic's lien statutes generally entitle a person that furnishes labor, material or services to a project to a statutory lien, or interest, against the real property being improved for the unpaid value of the labor, materials or services provided. No judicial determination of entitlement to the money claimed is required before the lien attaches to the property, and the property will stand as security for the debt owed to the unpaid contractor or supplier until such judicial determination is ultimately made and the debt paid. If the contractor or supplier files in a timely manner and serves the

mechanic's lien, it will have the legal right to sell the property to satisfy any amount ultimately adjudged by a court to be due. In the context of public improvements, the lien or interest attaches to the moneys due or to become due from the public entity to the prime contractor.³

Mechanics' lien laws can be very powerful and effective tools for securing

Subtle nuances and disparities in the laws create dangerous pitfalls for the unwary.

payment. In the case of an unpaid subcontractor, it is very common for an owner to either withhold payment to the general contractor for the amount of the lien or require the prime contractor to post a surety bond to stand as security for the lien; for if the owner continues to make payment to the prime contractor after receiving notice of a mechanic's lien, the owner may be held personally liable to the subcontractor for any moneys due to it. Moreover, a mechanic's lien is secured by the real property on which the improvement was made. The fact that the real property can be the owner's most significant asset and that lien rights with their priority status survive any bankruptcy make them very valuable in securing payment.

However, it is not the similarities in the laws for which a contractor or supplier needs to be aware, but rather the subtle nuances and disparities in the laws, which create dangerous pitfalls for the unwary. For example, contractors are sometimes required by the terms of their contracts to waive their

mechanic's lien rights at the inception of the project, before any work or services are performed. Many states permit such contractual waivers; others do not. How the parties treat these rights in their contracts is significant lest an unsuspecting contractor waive rights that it did not even realize it had.

Co-existing with the lien laws in many states are what are commonly referred to as trust fund statutes. (*See insert on trust fund statutes on the following page.*) These statutes are similar to the mechanic's lien laws in that they serve to protect those that furnish labor, materials or services in connection with a construction project. Generally, pursuant to the trust fund statutes,

any money received by an owner, contractor or subcontractor from a lender (in the case of an owner) or from the party with whom it has a contract (in the case of a contractor or subcontractor) is held in trust for the benefit of its subcontractors and suppliers on the project, and must be first applied to pay off claims of those subcontractors or suppliers before being used for any other purpose (e.g., covering the contractor's own home office overhead or profit). Unlike the mechanics' lien laws, though, the unpaid party typically need not do anything special to perfect its rights. If the money received is not properly applied according to the statute, the contractor may be found to have unlawfully diverted construction trust funds, subjecting itself and its principals to civil or even possible criminal liability. Such trust fund statutes, however, are only as strong as the financial viability of the contractor to whom the trust money was paid — if that contractor becomes bankrupt, there may be no assets with which to pay the claim.

Since most non-U.S. jurisdictions do not provide for the nonjudicial applica-

tion of liens, non-U.S. contractors are advised to familiarize themselves with these mechanisms and seek the necessary advice to protect their payments. Conversely, though, U.S. contractors doing work abroad cannot simply rely upon their standard form contracts, drafted against the backdrop of these laws, but must seek alternate means of payment protection.

Mechanics' Liens Outside the United States

With only a few exceptions, countries, including Mexico,⁴ most of Latin America⁵ and the United Kingdom,⁶ do not recognize the concept of mechanics' liens.⁷ Further, while these jurisdictions merely do not recognize the concept of mechanic's liens, other countries such as the United Arab Emirates specifically prohibit subcontractors from directly claiming any moneys or damages from the owner that are claimable against the contractor, unless the contractor specifically has given the subcontractor an assignment of rights against the owner (e.g., a liquidating agreement).⁸ Of those few jurisdictions that generally recognize mechanics' liens, which include various provinces of Canada (including Quebec) and New Zealand, a U.S. contractor will quickly find that its rights under those statutes can be significantly different from those to which it is accustomed.

Analogous lien law statutes to those found in the United States can be found in several of the Canadian common law provinces, such as the province of Newfoundland and Labrador. The Mechanics' Lien Act in this province applies to all contracts, and all subcontracts arising under those contracts, for services or materials used in the making, constructing, erecting, fitting, altering, improving or repairing of land, building, structure or works furnished to an owner, contractor or subcontractor. Like the lien laws in the United States, the lien attaches to the owner's interest in the real property being improved, and the lien is limited to the sum due to the lienor and the sum unpaid by the owner. There also are corresponding deadlines by which the contractor or subcontractor is required to file, serve and enforce its lien.

Quebec, on the other hand, the only code or civil law province in Canada, blends mechanic's lien concepts and the common code-country term: *hypothec*.⁹ A legal hypothec (a security interest arising by operation of law) may arise from the claim of a person taking part in the

Trust fund statutes are as varied and diverse as the mechanics' lien laws that they were designed to complement. Some statutes are merely criminal penal laws and give the contractor no civil right of action against the party that failed to pay it, while other statutes, despite their genesis in the state's penal laws, have been interpreted by courts as permitting civil recourse. Also, some statutes only apply to payments received by the general contractor and not by lower tiers, and some only apply to public projects.

Exemplifying the disparity in these laws are the trust fund laws in New York, New Jersey, Florida and California. New York has likely the most comprehensive set of trust fund laws in the country and they are part of the state's general Lien Law. It applies to all tiers on public and private construction projects, including the owners, and will subject the violator to civil and/or criminal liability. New Jersey's statute,

on the other hand, is a stand-alone law, applying only to moneys paid to general contractors on public improvement projects. Florida's statute, while enacted as part of the state's Construction Lien Law, makes the misapplication of construction funds a criminal offense. After a fast-track hearing, unpaid providers of labor, services or materials are entitled, upon proof, to the following civil remedies against receivers of such funds: an accounting, a temporary injunction and an attachment; the provider, upon proof, is also entitled to such other legal or equitable remedies as may be appropriate. Last, California does not have a specific statute denominating the payment of money on a construction project as trust funds, but courts in that state have viewed them to be trust funds where the parties' contract specifically requires the contractor's receipt of payment to be used for the payment of its subcontractors.

construction or renovation of an "immovable"¹⁰ to the extent of added value. There is a registration deadline after the end of the work to preserve the legal hypothec, as well as an enforcement deadline. Subcontractor rights exist, if the owner is notified of the subcontract, but the claim is limited to the work, materials or services supplied after such written declaration of the contract to the owner.¹¹

Instead of a "mechanic's lien," New Zealand employs a similar device known as a "charging order". However, pur-

and enforceable against the owner, subject to the owner's right to judicial review.

Conclusion

This is just a sampling of the few jurisdictions that have roughly equivalent statutory devices, but as previously stated, mechanics' liens and other analogous concepts do not exist in most jurisdictions. Therefore, without the benefit of a mechanic's lien, when performing work outside of the United States, any device to ensure payment will have to be contractual, requiring the contractor to closely review and negotiate strict payment rights and other protective measures to secure payment, such as parent company guarantees, or letters of credit. ■

Most non-U.S. jurisdictions do not provide for the nonjudicial application of liens.

suant to the Construction Contracts Act of 2002, unlike mechanics' liens in the United States and Canada, which can be applied with no judicial intervention, the charging order is not a prejudicial attachment. Before an owner's property may be encumbered by the claim of an unpaid contractor or subcontractor, there must first be an *adjudication* (an expedited quasi-judicial proceeding akin to an arbitration), to which the property owner is a party. If the adjudicator (arbitrator) renders a determination on the merits that the property owner is liable in whole or in part for the debt, the contractor will be entitled to a charging order against the owner's property, which will be binding

¹Because of this Tower of Babel-like diversity seen across the U.S. state statutory landscape, a Model Construction Lien Act was drafted by The National Conference of Commissioners on Uniform State Laws. However, since its finalization in 1987, no state legislature has adopted it.

²In the U.S., state law generally governs property rights, including lien interests. Similarly, the law of the state in which the real property is situated will determine how any mechanics' liens are handled.

³Fairly uniform throughout the various states is the concept that a lien may not attach to public property.

⁴2 U.S.-Mex. L.J. 167, 174.

⁵16-SPG Int'l L. Practicum 11, 12.

⁶Hudson's Building and Engineering Contracts, London, Sweet & Maxwell, 1995, ¶ 11.063, p. 1239.

⁷This article is not intended to be a comprehensive review of the status of mechanic's lien protections worldwide but rather takes a sampling of certain jurisdictions to highlight the need to review specifically payment protection mechanisms.

⁸UAE Civil Code, Article 891.

⁹This term is derived from the term *hypotheca* used in Roman law to denote a pledge or mortgage of property that remains in the possession of the mortgagor or debtor.

¹⁰Defined by statute as "Land and any constructions and works of a permanent nature located thereon and anything forming an integral part thereof," including "plants and minerals, as long as they are not separated or extracted from the land."

¹¹Civil Code of Quebec §2724, et seq. This concept is similar to the requirement for a "preliminary notice" in certain U.S. states.

Subcontractor's Knowledge of Project Conditions Bars Delay Claims

Metropolitan Steel Industries, Inc. v. Perini Corp. (2004)

In this recent New York case, the trial court reaffirmed the validity of no-damage-for-delay clauses in construction contracts. The court also clarified that the enforceability of these exculpatory contractual provisions, and the application of any exceptions thereto, are determined as of the time the contract is entered into, not at the time that the contract work is commenced.

In *Metropolitan Steel Industries, Inc. v. Perini Corp.*, Metropolitan Steel, doing business as Steelco, was Perini's steel subcontractor on a \$90 million design-build multistory bus depot (the Project) for the New York City Transit Authority (the NYCTA). Perini accepted Steelco's proposal, and Steelco commenced work in August 2000, but the parties continued to negotiate the terms and conditions of the subcontract for the next several months, finally entering the subcontract in February 2001. As is the case in most, if not all, NYCTA contracts, the prime contract contained a no-damage-for-delay clause that was incorporated by reference in the subcontract. In addition, the subcontract contained a clause that limited Perini's liability to Steelco for delay damages to whatever payment Perini received from the NYCTA for any such delays.

was not provided access to the Project site, and that site conditions interfered with its planned sequence of work. Nevertheless, Steelco entered into the subcontract at its original proposal price and took no exception to the limitation of liability provisions.

Steelco left the Project after being paid \$10,700,000 for contract work and change orders, and then commenced an action against Perini asserting a claim for delay damages of over \$3,500,000, among other claims. Perini moved to dismiss the delay claim based upon the no-damage-for-delay clauses in the prime contract and subcontract. In opposing this motion, Steelco primarily argued that the exculpatory clauses were not applicable because Steelco did not contemplate the changes to the drawings and the Project site at the time that its proposal was accepted in August 2000 and it started

In considering Steelco's arguments, the court focused on what delays were contemplated at the time that the subcontract was signed, as opposed to at the time Steelco commenced the work after Perini's acceptance of Steelco's proposal. In doing so, the court placed significance on the fact that when Steelco executed the subcontract in February 2001, Steelco was aware of all of the alleged changes to the structural steel drawings, as well as all of the Project site conditions that allegedly impeded its ability to efficiently erect the steel. The court further concluded that despite the extensive contractual negotiations conducted by Steelco, the subcontract did not contain any express provisions that prohibited Perini from rescheduling and resequencing the work. Therefore, the court held that the Steelco delay claims were barred. ■

Editor's Note

>>This case illustrates that New York courts will strictly enforce no-damage-for-delay clauses and incorporation by reference provisions, and that the exceptions thereto will not easily be overcome, especially when it is obvious that a contracting party is aware of the alleged interferences prior to execution of the agreement. Unfortunately, New York City agencies continue to utilize these clauses and the courts enforce them, even in circumstances that "push the envelope" of what types of delay could be contemplated. Of course, these clauses in public contracts are not subject to negotiation, and thus a contractor that wants to work for the city of New York must accept the fact that obtaining damages for delays can be a difficult proposition.

Most, if not all NYCTA contracts contain a no-damage-for-delay clause that is incorporated in the subcontract.

While Steelco was performing its work, but prior to the time the subcontract was executed, Perini's project designer made several changes to the preliminary structural steel drawings that Steelco had based its bid upon; Steelco also complained that it

work. Steelco further argued that Perini breached a fundamental contractual obligation by not adequately preparing the site for the commencement of the erection of steel and by rescheduling and resequencing Steelco's work.

A Little Corporate Housekeeping Can Help Avoid a Big Mess

The first part of the year is an ideal time to consider some

corporate housekeeping issues that are important to keep intact the limitation of liability advantage that the corporate entity affords to its shareholders. Too often, due to hectic business schedules, simple corporate housekeeping is overlooked; however, the failure to ensure that corporate formalities are being

followed can have a serious negative impact on the ability of a corporation to shield its shareholders from corporate debts. Creditors can use this as grounds to “pierce the corporate veil” and attempt to seize the personal assets of the shareholders to satisfy corporate debts. To avoid this, there are some simple corporate housekeeping tips that can be easily followed to avoid having a court ruling that the corporate shell should be disregarded and that the personal assets of the members are up for grabs.

Director and Shareholder Meetings

The corporation should hold formal annual director and shareholder meetings, maintaining minutes of those meetings in the corporate book. Furthermore, any outside-of-the-ordinary-course-of-business decisions should be approved by the board of directors, and, in certain cases, the shareholders, and records of meetings or written consents approving these decisions should also be preserved.

Organize Company Records

The minute books of the corporation should be updated to contain minutes of all director and shareholder meetings.

Review the Bylaws

The directors should review the bylaws to ensure that the corporation is operating in compliance therewith. Furthermore, a review of the bylaws will be helpful to determine if any changes are necessary as a result of changing business circumstances.

Elect New Officers and Directors and Remove Inactive Officers and Directors

Directors and officers who are simply filling slots and are not involved in, or are unfamiliar with, the day-to-day affairs of the corporation should be removed; people who will be actively involved in corporate affairs should be elected and installed as officers and directors. Resolutions to that effect should be prepared and filed in the corporate minute book.

Review Capitalization

The corporation should be capitalized in a sufficient manner to keep it running. Courts will consider the fact that a corporation is undercapitalized in making a determination as to whether or not the corporate veil should be pierced.

Make Sure Agreements Are at “Arm’s Length” and Documented

If the corporation has any agreements, especially with affiliates, directors, officers or shareholders, those agreements should be at arms length, that is, not on more favorable business terms than is normal for market conditions. All agreements should be in writing. The absence of such documentation may point toward a commingling of assets and/or an alter ego status of the corporation, factors that the courts will consider in making a determination to pierce the corporate veil.

Review Banking and Accounting Records

It is very important that corporate funds be maintained separately and not commingled with funds of shareholders or affiliated entities. A review of banking and accounting records should be performed to ensure that there is no commingling of funds. Furthermore, where funds are transferred between affiliates and shareholders, a legitimate business reason for such transfer should be documented.

These corporate housekeeping tips are not intended to be an exhaustive list of actions businesses should undertake, as courts can consider numerous other factors in determining whether or not the proper corporate formalities have been observed, such as fraud, insolvency, lack of corporate assets, payment of excessive dividends and improper use of corporate assets. But why risk your business and personal assets simply for lack of devoting a small amount of time each year to observe the simple formalities that provide such positive advantages? ■



» Stephen P. Katz, is a Partner and Director of Peckar & Abramson's Corporate Law Practice Group.



An Alternative to Performance Bonds — Advantages and Disadvantages of Subcontractor Default Insurance for the General Contractor

Over the last 10 years, the insurance industry has produced a product that, in some situations, provides an attractive alternative to performance bonds. Subcontractor Default Insurance (SDI) can provide security for contractors when a subcontractor breaches its contract and is terminated. There are many potential advantages to the contractor: (1) lower premium

costs; (2) control over the prequalification of subcontractors; (3) no investigation period by a surety after a subcontractor defaults; and (4) coverage of entities otherwise unqualified for a bond. From a contractor's perspective, there are also shortcomings with SDI, especially on public projects. This article will attempt to describe the pros and cons of SDI, as well as explain the workings of this relatively new product in the construction industry.

Conventional Performance Bonds Compared With Subcontractor Default Insurance

The deductible on an SDI policy is usually in the \$500,000 range, whereas performance bonds do not have a deductible. Additionally, on public projects, SDI policies may not meet the requirements for payment bonds, as mandated by the federal Miller Act and state public bond statutes, and SDI may

not satisfy the performance surety requirements in certain jurisdictions. As a result, SDI has been used primarily for private projects.

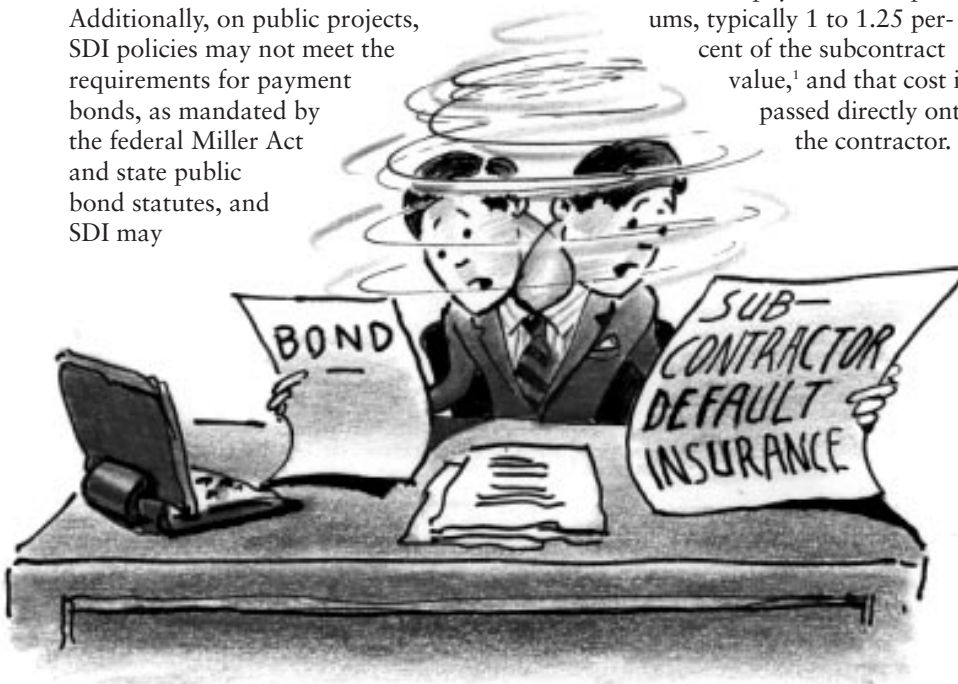
On a large construction project, conventional performance bonds set up a relationship between three parties — the bonding company (the surety), the subcontractor (the principal) and the contractor (the obligee). Subcontractors must be prequalified by the bonding company, and the bonding company assumes the risk of the subcontractor defaulting. In essence, the bonding company guarantees satisfaction of the subcontractor's obligations, and the bond constitutes protection for the contractor. The subcontractor pays the bond premiums,

typically 1 to 1.25 percent of the subcontract value,¹ and that cost is passed directly onto the contractor.

Once a contractor terminates a subcontractor, the bonding company's duties are triggered, and it is required to investigate the claim. Upon acceptance, the bonding company has certain options, including forfeiting the bond's penal sum, tendering a new subcontractor, financing the defaulted party or allowing the contractor to proceed at its own discretion (and at the bonding company's expense).² Many contractors have experienced the frustration of having to terminate a subcontractor, followed by a lengthy investigation by the bonding company. In a complex, time-sensitive project, any delays by a bonding company's investigation can be extremely expensive.

On the other hand, an SDI policy involves only two parties, as the contract specifies that the insurance company will compensate the contractor for losses resulting from a subcontractor's default. And rather than individual policies for each subcontractor, most SDI policies cover all subcontractors, and the contractor is free to decide which entities are qualified to perform work on the project. SDI policies usually cover first-tier subcontracts (subs in direct contract with the contractor), and second-tier subcontracts ("sub subs" in direct contract with first-tier subcontractors, including suppliers). SDI also provides coverage for losses that are the indirect result of a default, such as liquidated damages, acceleration of other subcontracts and extended overhead. SDI pricing is negotiable, usually ranging from 0.4 to 0.85 percent of total subcontract values, depending on the general contractors' experience and track record on similar projects.³

Three-party suretyship has been around for millennia, as have two-party insurance contracts. However, default protection and risk allocation in the U.S. construction industry has been primarily achieved through three-party bonding. Well-established statutes and



case law govern surety bonds in a wide variety of contexts, therefore providing clear guidelines to all parties in each jurisdiction. In contrast, there are no reported decisions on major subcontractor default insurance disputes, and it remains unclear how judges will treat SDI issues on construction projects. Regardless of how prominent default insurance becomes in the construction industry, this type of risk allocation is headed into uncharted territory.

Development of Current Policies

The most prominent policy on the market is Subguard®, a product of Zurich Financial Services. Subguard® was designed to address the needs of large general contractors, construction managers and design-build firms with annual subcontractor/supplier expenditures of \$50 million or more. Zurich's promotion of Subguard® highlights the following:

- Completion costs for unfulfilled subcontractor or supplier obligations — including costs related to contractor replacement, job acceleration and extended overhead

Many contractors have experienced the frustration of having to terminate a subcontractor, followed by a lengthy investigation by the bonding company.

- Correction costs for defective and/or nonconforming work product
- Legal costs resulting from a default
- Coverage for disadvantaged or small business enterprises that may have difficulty qualifying for standard performance and payment bonds
- Coverage for local and other business enterprises that may have difficulty qualifying for standard performance and payment bonds⁴

Under Subguard®, Zurich negotiates the deductible and co-payment amounts of the policy based on the particular project and the contractor's history with subcontractors. All subcontracts signed after execution of the policy are covered, and suppliers can be included by endorsement to the policy. A contractor can therefore manage and control risk by including, for example, suppliers of concrete, construction materials and equipment all under one policy.⁵ When a claim arises, contractors notify the insurer in writing of the

subcontractor's default, and then proceed independently to remedy the situation. Contractors are reimbursed for their costs, less deductibles and co-pay amounts.

Bad-Faith Claims

Default insurance like Subguard® is bound by the traditional implied covenant of good faith and fair dealing in insurance contracts. Therefore, a contractor has the legal remedies under an insurance contract, including punitive damages, if an SDI provider does not fulfill its obligations after a contractor has established a claim. In contrast, surety interests have fought hard against the ability of a contractor, as obligee, to recover against the surety company on bad-faith claims. While there is a developing line of cases holding sureties liable for bad-faith refusal to pay and delay in processing claims (*See casenote, USF&G v. Braspetro Oil Services, Co., on page 5 of the Fall edition of this newsletter*), not all jurisdictions have followed suit. A surety company successfully argued in a 1999 California Supreme Court case (*Cates Construction, Inc. v. Talbot Partners*) that a

surety's obligations to a contractor are distinguishable from the obligations under a two-party insurance contract.⁶ Thus, in terms of bad-faith claims and punitive damages, a contractor may have more rights under a two-party insurance contract.⁷

The National Association of Surety Bond Producers has characterized SDI as a "big gamble" because there may be no extensive checks on subcontractors.⁸ Surety interests emphasize the merits of the subcontractor prequalification process, and suggest that the three-party nature of bonds helps mitigate potential losses. And proponents of surety bonds point out that SDI is no replacement for payment bonds, as there is no protection afforded to subcontractors or suppliers.

Informal disputes involving public projects highlight the potential for litigation. Major construction companies have used SDI while employing various project delivery systems. When a general contrac-

tor or construction manager at-risk relationship is established with public entities, federal and state surety laws must be carefully examined. Surety interests have sought to prevent the use of SDI in lieu of performance bonds on public projects, yet no formal litigation has led to a reported judicial decision on the issue.

The Miller Act and similar state laws are designed to protect taxpayer funds and ensure timely completion of public projects. The legal mechanisms for achieving these goals evolve, and it may turn out that SDI may come into prominent use on public projects. As proponents of surety bonds continue to promote their interests, however, there will no doubt be litigation on the applicability of SDI with the use of public funds. Similarly, with private projects, there are bound to be lawsuits regarding coverage issues and other provisions in SDI policies.

Conclusion

SDI can provide a good alternative to performance bonds in many settings. Large contractors that have the resources to investigate subcontractors and suppliers will benefit from the lower costs of default insurance. Indeed, the contractor is often the best party to evaluate the strength of a subcontractor, based both on balance sheet factors and intangible qualities, and make key decisions about project participants. On the other hand, smaller contractors may be better served by the established three-party surety relationship when addressing the risk of subcontractor default. A bonding company's prequalification of a subcontractor can be a valuable loss-prevention measure for many contractors. ■

¹Jeffrey A. Ford, Esq., "Subcontractor Default Insurance," presentation to the Construction Law Section of the State Bar of Texas, March 8-9, 2001.

²Klinger, Marilyn, and Diwick, James P., *The Contract Performance Bond, The Law of Suretyship*, 7-5 through 7-11 (Edward Gallagher, ed., 1993).

³Notebloom, Lowell J., Esq. From the website of Leonard, Street, and Deinard, Minneapolis, MN. Subguard® Subcontract Insurance — What is it? Is it an appropriate alternative to surety bonds? 2001.

⁴Gray, Terry. Vice President, Construction Risk, Zurich N.A. Insurance Co. Point/Counterpoint; Default Insurance — An Alternative to Traditional Surety Bonds. 22 WTR Construction Law 17. 2002.

⁵Id.

⁶See *Cates Construction, Inc. v. Talbot Partners*, 980 P.2d 407, 427 (1999).

⁷In the event that the Florida Supreme Court permits its bad-faith actions against sureties by bond obligees, such as owners, this will likely result in judgments greater than the face amount of the bond that could ultimately lead to increase bond premiums as well as an increase in the amount of collateral required to be posted by bond principles. The implications to Florida's construction industry cannot be overstated. We will keep you advised in future editions of the newsletter.

⁸Cashion, Matthew K. Jr., President, National Association of Surety Bond Producers, June 9, 2003 Opinion Letter, McGraw Hill Companies, Inc.

New Jersey Upholds Pre-Work Notice Requirement for Public Payment Bond Claims

Dial Block Company, Inc. v. Mastro Masonry Contractors (2004)

The New Jersey Public Works Bond Act was amended in 1996 to provide that potential claimants under the bond, not in direct contact with the general contractor, must provide notice to the general contractor before commencing work or supplying materials to the project. The purpose of the changes to the statute was to alert general contractors to the presence on the

construction project of third-tier subcontractors and suppliers who may later claim to be payment bond beneficiaries. That way, the general contractor can then provide a certain measure of protection to these entities when paying subcontractors that the general contractor has contracted with directly. In this case, the general contractor was constructing a school for the Atlantic County Special Services School District. In accordance with the Public Bond Act, the contractor posted payment and performance bonds. Thereafter, the general contractor entered into a purchase order with Mastro Masonry Contractors (Mastro) for Mastro to provide labor, materials and equipment to complete all unit masonry pavements. Mastro, in turn, requested that Dial Block Company, Inc. ("Dial") supply the materials. As a condition for doing so, however, Dial requested that the parties enter

into a joint checking agreement by which the general contractor agreed to issue joint checks to Mastro and Dial for the materials supplied to the project. The general contractor prepared the agreement and provided that the total material cost was not to exceed \$125,000. After Dial had supplied Mastro with more than \$300,000 in materials, Dial requested that the agreement be amended to raise the cap to \$500,000. The general contractor refused due to cost overruns by Mastro and because Mastro already had been paid in full. In fact, the general contractor had issued over \$347,007 in joint checks to Dial and Mastro. Dial was still owed \$65,000 from Mastro.

The general contractor and its surety refused to honor Dial's claim because Dial had not filed the statutory pre-work notice. However, Dial contended that the joint check agreement constituted a direct contract, and, therefore,

that Dial was not required to provide the general contractor with notification prior to doing work. Dial also argued that the joint checking agreement constituted sufficient pre-work notice to qualify it as a beneficiary.

The trial court rejected both arguments, and the appellate court affirmed. The court found that the joint checking agreement was not a "direct contract" with the general contractor. In addition, the joint check agreement did not constitute written notice of Dial's status as a beneficiary before it commenced work because Dial had failed to state in any written notice that it was a potential beneficiary of the bond. ■

Peckar & Abramson

is pleased to announce the relocation of its Los Angeles office on May 1st:

**550 South Hope Street
Suite 1655
Los Angeles, CA 90071
Telephone: 213.489.9220
Facsimile: 213.489.9215**

BULLETIN

Peckar & Abramson Newsletter
Volume XV, Issue 1, Spring 2005
Charles F. Kenny, Esq., Editor

Peckar & Abramson, P.C.
Attorneys at Law

New Jersey
70 Grand Avenue
River Edge, NJ 07661
Telephone: (201) 343-3434
Facsimile: (201) 343-6306

New York
546 Fifth Avenue, 17th Floor
New York, NY 10036
Telephone: (212) 382-0909
Facsimile: (212) 382-3456

San Francisco
250 Montgomery Street, 16th Floor
San Francisco, CA 94104
Telephone: (415) 837-1968
Facsimile: (415) 837-1320

Los Angeles
550 South Hope Street, Suite 1655
Los Angeles, CA 90071
Telephone: (213) 489-9220
Facsimile: (213) 489-9215

Miami
One Southeast Third Avenue, Suite 3050
Miami, FL 33131
Telephone: (305) 358-2600
Facsimile: (305) 375-0328

Fort Lauderdale
401 East Las Olas Boulevard
Suite 1600
Fort Lauderdale, FL 33301
Telephone: (954) 764-5222
Facsimile: (954) 764-5228

E-mail: mail@pecklaw.com
Web site: www.pecklaw.com

© Copyright 2005 by Peckar & Abramson, Attorneys at Law. Permission to reprint granted with appropriate credit. This newsletter provides general information only. It is not legal advice and should not be used as a substitute for review with counsel of your specific situations. Designed by Shostak Studios, Inc., NYC.

