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newsletter

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The Federal Small Business Programs:

Opportunities for Large and Small Contractors

With the decline in private construction projects across the United States and the proposed increase in federal construction spending, many construction contractors are seeking to increase the amount of their federal government contract work. Because a significant portion of the federal spending will be set aside for small businesses, many construction contractors are actively seeking to contract with small business on these set-aside projects. This article will briefly describe the federal small business programs and the limitations a large business faces when contracting with a small business.

The Small Business Administration (SBA) has five main small business programs: (1) the small business program; (2) the small disadvantaged business (SDB) program/8(a) business development program; (3) the historically underutilized business zone (HUBZone) program; (4) the service-disabled veteran-owned small business (SDVOSB) procurement program; and (5) the women-owned small business program (WOSB). There are different qualification requirements and benefits of each program. A small business may qualify for more than one program.

The federal government has established goals for the award of prime contracts and subcontracts to small businesses. Theses goals are as follows:

23 percent of prime contracts to small businesses;

5 percent of prime and subcontracts for small disadvantaged businesses;

5 percent of prime and subcontracts for women-owned small businesses;

3 percent of prime and subcontracts for HUBZone businesses; and

3 percent of prime and subcontracts for service-disabled veteran-owned small businesses.

Small Business Program

In order to qualify as a small business, a company must be small, independently owned and operated, and not dominant in its field. SBA has established size standards for various types of businesses for the purpose of determining whether a company is small. These size standards are either revenue based or employee based. The company must have fewer employees or less annual receipts than the stated size standard in order to qualify as a small business concern. The size standards for construction are revenue based and range from $7 million to $33.5 million in average annual earnings per year.

In determining whether a company is a small business, the affiliates of the company will be considered. The number of employees or annual receipts of the company and its affiliates will be added together to determine if the company meets the applicable size standard. Companies are considered to be affiliated if, directly or indirectly, either one controls or has the power to control the other, or another concern controls or has the power to control

ILLUSTRATIONS: LIAM ROBERTS

both. In determining if companies are affiliated, SBA will look at various factors, including common ownership, common management, and contractual relationships such as joint ventures, teaming agreements, and subcontracts.

Unless the company is applying for financial assistance from SBA, there is no need to apply to SBA for a small business certification. The company can represent that it is a small business as part of the procurement as long as it has a good faith belief that it meets the size standard established by SBA.

Small Disadvantaged Business (SDB) /8(a) Business Development Program

The SDB program offers federal government procurement assistance and benefits to small disadvantaged businesses. A subset of the SDB program is the 8(a) program, which provides business development assistance to its members that goes beyond procurement benefits. While all 8(a) concerns are SDBs, not all SDBs are 8(a)s.

To qualify as an SDB, the company must be a small business that is at least 51 percent directly and unconditionally owned and controlled by a socially and economically disadvantaged individual or individuals. As part of the control requirement, the management and daily business operations of the company must be conducted by one or more disadvantaged individuals.

Socially disadvantaged individuals are those who have been subjected to racial or ethnic prejudice or cultural bias within American society because of their identities as members of groups and without regard to their individual qualities. There is a presumption that members of certain ethnic groups are socially disadvantaged. Other individuals outside these groups can qualify as socially disadvantaged if they show by a preponderance of the evidence that they are socially disadvantaged.

In addition to being socially disadvantaged, the individual(s) who own and control the company also must be economically disadvantaged. An individual is economically disadvantaged when his/her ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same or similar line of business who are not socially disadvantaged. The individual must have a net worth of less than $750,000 ($250,000 for the 8(a) program) excluding the equity in the business and his/her primary residence.

In 2008, there were several significant developments regarding the SDB program. On October 1, 2008, SBA announced that it would no longer certify SDB status. SBA has issued an interim proposed rule that would allow the procuring agency to certify whether an offeror is an SDB and to allow the company to self-certify. SBA continues to certify 8(a)s.

Shortly thereafter, in November 2008, the Court of Appeals for the Federal Circuit held that the statute that permitted the U.S. Department of Defense to adjust bid prices to give SDBs a price evaluation preference was unconstitutional and enjoined its application. The court found that the federal government did not have sufficient evidence of pervasive nationwide racial discrimination by the Department of Defense to justify the evaluation preference program. The impact of this decision on the future of 8(a) set-asides is unclear. While 8(a) set-asides are authorized under a different statute, the 8(a) program has the same race-based preference.

Historically Underutilized Business Zone (HUBZone) Program

In order to assist small businesses located in distressed communities, federal agencies are authorized to restrict entire procurements for award to small businesses in HUBZones. To meet the 3 percent award goal, procurements may be set-aside for HUBZone small businesses when the contracting officer has a reasonable expectation that offers will be received from two or more HUBZone small businesses and award will be made at a fair market price. Contracting officers also may include small business HUBZone status as an evaluation factor. The contracting officer may give offers from HUBZone small businesses a price evaluation preference by adding a 10 percent factor to the offers submitted by large businesses.

HUBZone small businesses must be certified as such by SBA. To qualify as a HUBZone small business, a company must be a small business, be owned and controlled by one or more U.S. citizens, have its principal office in a HUBZone and have at least 35 percent of its employees reside in a HUBZone.

Service-Disabled Veteran-Owned Small Business (SDVOSB) Procurement Program

Federal agencies also may set aside or sole-source procurements for SDVOSBs to meet the 3 percent SDVOSB goal. To qualify as a SDVOSB, a company must be a small business, and must be owned and controlled by one or more service-disabled veterans. A service-disabled veteran is a veteran who has been determined by the Department of Veterans Affairs (VA) to have a service-connected disability. The veteran must have either a disability rating letter issued by the VA or a disability determination from the U.S. Department of Defense. A company may self-certify that it is a SDVOSB if it has a good faith belief that it meets the applicable size standard and ownership and control requirements.

The VA has special buying authority under the Veterans First Contracting Program that permits the VA to change its contracting priorities to give preference to SDVOSBs and veteran-owned small business concerns (VOSBs) that are not owned and controlled by service-disabled veterans. In addition, the VA also has increased set aside and sole-source contracting authority for SDVOSBs and VOSBs. In order to be eligible for the Veterans First Contracting Program, the SDVOSB or VOSB's ownership and control must be verified by the VA. In addition, the VA requires that its large prime contractors use SDVOSBs and VOSBs that have been verified by the VA.

Women-Owned Small Business (WOSB) Program

Perhaps the most controversial small business program is the women-owned small business (WOSB) program. In 1994, Congress enacted legislation establishing a goal of awarding 5 percent of the federal contract dollars to WOSBs, a goal that has not been met. As a result, in 2000, Congress passed the Equity in Contracting for Women Act, which authorized federal agencies to set aside procurements for economically disadvantaged women-owned small businesses (EDWOSBs) on procurements not exceeding $3 million ($5 million for manufacturing) in industries where EDWOSBs are underrepresented. The act also authorized federal agencies to waive the economically disadvantaged requirement if SBA determined that the procurement involved an industry where WOSBs are substantially underrepresented.

After a seven-year delay, SBA issued proposed regulations to implement the act. The proposed regulations identified only four industries in which WOSBs were underrepresented; construction was not one of

The size standards for construction are revenue based and range from $7 Million to $33.5 Million in average annual earnings per year.

those industries. Despite heavy criticism of the proposed regulations, SBA issued final regulations on October 1, 2008. The regulations increased the number of industries in which women are underrepresented to 31, but did not identify the industries. Instead, SBA requested public comments. In January 2009, SBA announced that it was re-opening and extending the comment period until March 19, 2009. However, the Omnibus Spending Bill signed by President Obama on March 11, 2009, precludes SBA from using any of its funds to implement the WOSB regulations as they currently stand.

. . . a small business and a large business can work together to compete on a government set-aside by a teaming agreement . . .

Joint Ventures with Small Businesses

Some large businesses believe that they can circumvent the size restrictions in set-aside procurements by joint-venturing with a small business. The scenario often proposed is for the small business to submit the proposal in its name and identify the large business as a subcontractor. The large business will provide bonding and other financial assistance to the small business, and will manage the day-to-day operations of the project, and the parties will split any profits. Under this scenario, however, the parties are joint venturers and not eligible for the set-aside award, regardless of the fact that the parties enter into a formal joint-venture agreement.

If a large business enters into a joint venture with a small business, the resulting joint- venture entity does not qualify as a small business for the purpose of a government set-aside. SBA considers joint-venture partners to be affiliates for purposes of the contract on which they are joint-venturing. The SBA regulations define a joint venture as "an association of individuals and/or concerns with interests in any degree or proportion by way of contract, express or implied, consorting to engage in and carry out no more than three specific or limited-purpose business ventures for joint profit over a two-year period, for which purpose they combine their efforts, property, money, skill or knowledge, but not on a continuing or permanent basis for conducting business generally." 13 C.F.R. § 121.103(h). A joint-venture need not be in the form of a separate legal entity. Thus, SBA may determine that the relationship between a prime contractor and its subcontractor is a joint venture and that affiliation between the two exists.

There are some limited exceptions to the affiliation based on joint-venture rule. These exceptions generally involve two small businesses entering into a joint venture. However, there is an exception under SBA's 8(a) regulations for mentor/protégé agreements. Two firms approved by SBA to be a mentor and a protégé may joint-venture as a small business for any federal government procurement, provided the protégé qualifies as small for the size standard corresponding to the North American Industry Classification System (NAICS) code assigned to the procurement and, for purposes of 8(a) sole source requirements, has not reached the dollar limit set forth in 13 C.F.R. § 124.519. This exception does not apply to the Department of Defense's Pilot Mentor Protégé Program. Mentors and protégés under the pilot program may be considered affiliated if they joint-venture or even subcontract.

Teaming with Small Businesses

One way in which a small business and a large business can work together to compete on a government set-aside is by a teaming agreement whereby the small business is the prime contractor and the large business is a subcontractor. The federal government will recognize the integrity and validity of a teaming agreement if the agreement is fully disclosed in the proposal or, for agreements entered into after the submission of the proposal, before the agreement becomes effective.

The fact that the parties label their agreement a teaming agreement and not a joint-venture agreement, however, is not dispositive. SBA may determine that the parties are affiliated as a joint venture under the ostensible subcontractor rule. The SBA regulations define an ostensible subcontractor as a subcontractor that performs primary and vital requirements of a contract or a subcontractor upon which the prime contractor is unusually reliant.

In determining whether a subcontractor is an ostensible subcontractor, SBA will consider all aspects of the parties' relationship including, but not limited to, the terms of the proposal (such as contract management, technical responsibilities and the percentage of subcontracted work), agreements between the prime contractor and subcontractor (such as bonding assistance or the teaming agreement), and whether the subcontractor is the incumbent contractor and is ineligible to submit a proposal because it exceeds the applicable size standard for that solicitation. SBA also may consider seven factors in determining whether the parties are affiliated under the ostensible subcontractor rule. Those factors are:

- ❖ Which party will be managing the contract?
- ❖ Which party possesses the requisite background and expertise to carry out the contract?
- ❖ Which party pursued the contract award?
- ❖ What degree of collaboration was there on the proposal effort?
- ❖ Were the tasks allocated to be performed by each party, or is there commingling of personnel and material?
- ❖ What is the amount of work to be performed by each party?
- ❖ Which party will perform the more complex and costly contract functions?

These factors, however, are not exclusive or exhaustive, and SBA will consider other factors if they are relevant.

In order to help avoid a finding of affiliation, the teaming agreement should:

- ❖ Cover only a singled, specifically identified acquisition. A teaming agreement that is continuing in nature may indicate that the prime contractor is unduly reliant on the subcontractor.
- ❖ Identify the portion of the work to be performed by the prime contractor and the subcontractor. The work should be allocated based on discrete tasks consistent with the solicitation and not on a percentage of the work. The prime contractor must have control over the daily management of the contract work and must be solely responsible for contract performance.
- ❖ State the price to be paid to the subcontractor to the extent possible.
- ❖ Specify each party's role in the proposal preparation. The prime contractor should have the ultimate control and responsibility for proposal preparation and communication with the customer. In general, the subcontractor's contribution to the proposal preparation should be limited to the subcontractor's scope of the work, rather than provide for the sharing of profits or losses.

Peckar & Abramson's Government Contract Practice Group counsels large and small businesses regularly with respect to the federal government's small business programs. Please contact us with any questions or issues that you may have as your company attempts to navigate this complex regulatory environment.

Lori Lange, Associate, Washington, D.C. ■

article

Safeguarding Contractual Indemnification Rights When Settling Third-Party Claims

Construction project participants often face legal claims for matters that ultimately are the responsibility of another party. For example, contractors are normally the targets of owners' claims for damages for the defective or incomplete work of subcontractors. To deal with this situation, most long-form contracts include an indemnity clause similar to the following subcontract provision:

> Subcontractor shall fully indemnify, defend and save harmless contractor from any and all claims, demands and causes of action of every nature, which might be made or asserted against contractor, by reason of or in any manner pertaining to subcontractor's performance of the work herein contracted or any failure of subcontractor to comply with the terms of this agreement, including attorney's fees and other expenses incurred by contractor in the defense of any such claim, demand or cause of action.

If the contractor is held liable to the owner, such a clause allows the contractor to pass the liability on to the responsible subcontractor and collect all or some of the funds expended. The following cases discuss contractors seeking indemnity or reimbursement from subcontractors as a result of contractors having to pay and/or defend owner claims.

Contractors often choose to settle owner's claims before a final judgment or arbitration award is rendered. Reasons for this may include the desire to maintain a good relationship with the owner, the need to resolve a dispute quickly, or the inability to bring the subcontractor into the lawsuit or arbitration. In the absence of a ruling establishing the contractor's liability to the owner, on what basis can the contractor obtain reimbursement from the subcontractor? This article reviews how courts have viewed these situations, and outlines some steps for maximizing the contractor's ability to recover from subcontractors for settlements with the owner.

Indemnification Is Available for Settlements

As a preliminary matter, it is clear that contractors can be indemnified for settlements. A contractor need not litigate or arbitrate an owner's claim all the way to a judgment or award in order to establish its right to indemnity from the subcontractor ultimately responsible.

However, how the contractor handles the settlement and the events leading up to the settlement can have a major impact on how easily indemnification is obtained. The contractor's goal is to secure indemnification without having to litigate against the subcontractor the issues of (1) whether the contractor was actually liable to the owner, or (2) what the owner's actual damages were.

Assuming the claim meets the prerequisite of falling within the scope of the subcontract's indemnity clause, a contractor can most easily obtain indemnification for a settlement payment to the owner when (1) the subcontractor received adequate notice of the underlying proceedings and an opportunity to defend or participate, (2) the contractor was potentially liable to the third party, and (3) the settlement was reasonable. Each of these requirements is examined here in detail.

Notice to the Subcontractor

If the subcontractor/indemnitor had been given notice and the opportunity to assume responsibility for the claim through defense or participation in settlement, the contractor need only show that its settlement with the owner was reasonable. Without such notice, the contractor can still obtain indemnification, but it must show that it was actually liable to the owner. Therefore, notice is critical to easing the indemnification claim.

Whether the notice given is sufficient depends on the circumstances. In one case, three weeks' notice of a settlement mediation was found to be adequate where the subcontractor was already aware of the underlying lawsuit. In another case, two weeks' notice of settlement conferences was implicitly found to be reasonable where the subcontractor already knew of the lawsuit. On the other hand, one or two days' notice of impending settlement discussions will not be sufficient, especially if the subcontractor was not previously aware of the owner's claim.

To best ease the path to obtaining indemnification, the contractor should give the subcontractor prompt notice of any claim or lawsuit by the owner that could possibly give rise to indemnification. A demand for indemnification or a tender of defense should be included in the notice. If settlement discussions are scheduled, the subcontractor should be notified. Frequently, contractors prefer that subcontractors not participate in settlement discussions with the owner. If that is the case, before settling the owner's claim, the contractor should at least inform the subcontractor of the amount of the tentative settlement and state that the contractor will settle the case unless the subcontractor assumes the defense and agrees to hold the contractor harmless.

Contractor's Potential Liability to the Owner

Potential liability is the trigger for indemnification. It is required to avoid having the party seeking to be reimbursed from being considered a mere volunteer, i.e., settling the

underlying claim when there was no exposure whatsoever. "Potential liability" has been characterized differently by different courts. In a non-construction case, the court looked at whether the owner's claim was "not frivolous," whether there was a "reasonable apprehension of liability," and whether there was any "fraud or collusion" between the settling parties. In another non-construction case, the court found it sufficient that the counsel for the party seeking reimbursement had concluded that there was "a possibility that a substantial judgment would be rendered" against his client. It has been held that the threshold for potential liability is not high when proper notice has been given and the notified party has elected not to act.

Whether there was potential liability will depend on the circumstances of the particular case, but it should not be too difficult to establish unless the contractor ignored clear-cut facts or arguments that would have defeated the owner's claim. However, the matter becomes complicated when a contractor enters into a global settlement of claims based on multiple theories, some within the scope of the indemnity clause and some not. In that situation, the contractor must show that it was not liable on any theory outside the indemnity clause's scope, that it was potentially liable on a theory covered by the indemnity clause, and that the settlement of the exposure on that covered theory was reasonable.

Reasonableness of Settlement with the Owner

The last requirement for obtaining indemnification for a settlement is a showing that the settlement was reasonable. Reasonableness will be judged based on two interrelated components: the amount paid in the settlement and the risk of exposure if the matter were to be tried. Thus, the higher the risk of exposure, the greater the settlement payment can be and still be reasonable. Only where the payment is too high in relation to the exposure will a settlement be unreasonable. The burden is on the contractor to show that its settlement was reasonable.

Establishing reasonableness becomes more difficult when there is a global settlement of multiple claims. Frequently, not all claims are the fault of a single subcontractor. In this situation, the contractor should attempt to apportion amounts paid in settlement among the different claims in a written settlement agreement. Without such agreed apportionment, the subcontractors cannot determine the extent of their liability under the indemnity clause. This will result in the contractor having to prove that the amount it has decided to seek to recover from each subcontractor corresponds to the actual cost of repairing each subcontractor's respective defective work.

Conclusion

If the process is properly managed, a contractor should be able to obtain full indemnification from a subcontractor for settlements with the owner without having to litigate all aspects of liability and damages. The keys are proper notice to the subcontractor up front, an accurate evaluation of potential liability to the owner and a reasonable settlement.

Nick R. Hoogstraten
Associate, Washington, D.C.

<<ALERT>>

THE NEW STIMULUS ACT:

Does It "Federalize" State and Local Contracts? Does It Change the Risk Calculus for Contractors Performing Public Contracts?

"The American people are watching. They need this plan to work. They expect to see the money that they've earned — they've worked so hard to earn — spent on its intended purposes without waste, without inefficiency, without fraud."

President Obama to U.S. mayors, February 20, 2009

The sheer scope of the $140 billion in construction spending authorized by the newly enacted American Recovery and Reinvestment Act of 2009 (popularly known as the Stimulus Act) is certain to accelerate the ongoing market shift from private to public construction spending. This shift has caused traditional private-sector contractors to pursue public work, many for the first time. For contractors already experienced in public works as well as newcomers to the public contracts marketplace, an important question to consider is whether the baggage of the Federal Acquisition Regulations (commonly know as the FAR) will accompany contracts funded by the Stimulus Act.

The short answer is "no;" the Stimulus Act imposes the FAR only on contracts entered with a federal agency. Stimulus Act–funded projects entered into with state and local governments are not governed by the FAR, but are instead subject to the governing state and local procurement laws. This short answer is, however, an incomplete answer. Just as FAR clauses and requirements may be incorporated into federally funded state and local contracts on an agency-by-agency and contract-by-contract basis, and federal grant rules may impose elements of the FAR, contracts funded by the Stimulus Act may still be subject to FAR terms, depending on the specific terms of the contracts.

Another important question is the level of risk that Stimulus Act contractors will assume. The answer is that *all* Stimulus Act contracts– at the federal, state and local levels– will be subject to careful scrutiny by auditors for fraud, waste and abuse. Wasteful spending and poor contract administration of Stimulus Act contracts may be investigated by the federal inspector general (IG) of the contracting agencies and by the newly constituted Recovery Accountability and Transparency Board. After passage of the act, the Obama Administration issued a directive that "fraud, waste, error and abuse" must be "mitigated" and cost overruns must be avoided with Stimulus Act–funded contracts.

In addition, even if the FAR does not apply to state and local contracts, this does not mean that federal ethics laws will not apply. For example, Stimulus Act–funded contracts with state and local governments

may be subject to the federal False Claims Act, depending on whether payment requests are approved by the federal government. Finally, although the recently enacted FAR ethics regulations requiring federal contractors to institute compliance programs and to "self-disclose" ethics violations will not be imposed on state and local contractors, those requirements will still apply to federal contracts funded by the Stimulus Act. All of this suggests that, although contractors with state and local contracts funded by the Stimulus Act will not have to deal with the same FAR baggage as federal contractors, elements of the FAR may still apply, and *all* Stimulus Act contractors must understand that the current tide of ethics enforcement will only continue to rise.

The Stimulus Act's Treatment of the FAR

Both the House bill and the original Senate bill would have imposed the FAR on *all* projects funded under the Stimulus Act, whether contracted directly with a federal agency or through a grant to a state or local government. In effect, these bills would have placed contractors with state and local contracts in the same position as contractors with the federal government. The final Senate compromise bill, however, pulled back from this blanket application of the FAR, and instead limited the FAR's application to federal projects only. The conference report for the Stimulus Act offers little or no explanation for the elimination of the blanket FAR requirement, but it is known that representatives of the construction industry lobbied to limit the FAR requirements to federal procurements only. The industry apparently convinced Congress that requiring state and local governments to suddenly conform their procurement practices to an unfamiliar federal regulatory framework would inject confusion and risk into a stimulus program whose goal is to encourage swift economic activity. However, elimination of the mandatory blanket application of the FAR does not mean that FAR requirements may not be imposed in a given contract. Note that, although the FAR's requirements for competitive contracting do not apply to state and local contracting under the Stimulus Act as enacted, the Obama administration is nevertheless committed to maximizing competition in contracting. On February 18, 2008, the White House's Office of Management and Budget (OMB) issued to all federal agencies a detailed memorandum entitled "Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009." In describing procurement practices for Stimulus Act contracts, the OMB directed, "Agencies should review their internal procurement review practices to *promote competition to the maximum extent practicable*." Therefore, competitive contracting practices mandated by the FAR may be implemented even if the FAR itself does not apply.

State and Local Procurement Not Free From Federal Strings

The final Stimulus Act language removing the blanket application of the FAR does not mean that Stimulus Act contractors are free from the FAR's requirements. To the contrary, contractors performing state and local construction contracts funded by federal appropriations *can* be made subject to FAR compliance. Whether by agency rule, as a condition attached to a grant, or by the inclusion of FAR requirements in a state or local solicitation for bids, contractors performing state or local contracts are often required to comply with key requirements of the FAR. Common examples include the inclusion in state highway contracts of various federal labor, affirmative action and employment practices requirements, such as the Davis-Bacon Act requirements found in FAR 52.222-6. The federal agencies disbursing Stimulus Act funds to state and local governments will surely continue their practice of imposing these FAR socio-economic requirements on Stimulus Act–funded projects.

Oversight of Procurement Integrity

The depth and breadth of federal contractors' procurement integrity obligations under the FAR have increased substantially over the past 18 months, culminating in the recently enacted FAR regulations requiring federal prime contractors and subcontractors to voluntarily self-disclose violations of federal ethics laws and the civil False Claims Act, and substantial overpayments. Contractors new to federal procurement must cope with these ethics requirements and train their workforces accordingly, with a full appreciation for the risks contractors face in pursuing federal work. This concern can only be intensified for contractors on Stimulus Act–funded projects because of the act's commitment to transparency and accountability. Stimulus Act contractors will be under the microscope for fraud, waste and abuse. All funds expended under the Stimulus Act are subject to audit under the "Accountability and Transparency" provisions under Title XV of the act. A Recovery Accountability and Transparency Board has been established, whose powers include "auditing and reviewing covered funds to determine whether wasteful spending, poor contract or grant management or other abuses are occurring, and referring matters it considers appropriate for investigation to the inspector general for the agency that disbursed the covered funds." The board is authorized to conduct its own audits, as well as collaborating with the IGs of the agencies, and will exercise the full investigative powers afforded IGs under the Inspectors General Act of 1978, including the power to issue subpoenas. These oversight responsibilities are to be coordinated with state auditors. Contractors thus face possible investigations for fraud, waste and abuse from at least two and possibly three sources– the Recovery Accountability and Transparency Board, the agency IGs, and, if a grant project, a state or local IG. The Stimulus Act thus gives the federal government additional tools to prevent, detect and prosecute fraud, waste and abuse. The commitment to use these tools to carry out President Obama's promise not to permit waste, inefficiency or fraud is reflected in recent administration policy directives. The OMB memorandum issued to federal agencies on February 18, 2008, identifies the Obama administration's accountability objectives as:

- Funds are awarded and distributed in a prompt, fair and reasonable manner;
- The recipients and uses of all funds are *transparent to the public*, and the public benefits of these funds are reported clearly, accurately and in a timely manner;
- Funds are used for authorized purposes, and *instances of fraud, waste, error, and abuse are mitigated;*
- Projects funded under this act *avoid unnecessary delays and cost overruns*; and
- Program goals are achieved, including specific program outcomes and improved results on broader economic indicators.

The OMB memorandum advises agencies to "give special attention" to determining the responsibility of federal contractors. Responsibility determinations are governed by Part 9 of the FAR, which in turn includes the recently enacted regulation requiring that contractors "self-disclose" ethics violations or risk suspension and debarment as well as disqualification as a non-responsible bidder. The special attention to be devoted to responsibility determinations means that the potential risks associated with a contractor's failure to make a required disclosure have magnified.

The spotlight on fraud, waste and abuse intensified shortly after the passage of the Stimulus Act, when the IG of the U.S. Department of Transportation (USDOT) issued a scathing report charging state and local contractors with failing to comply with federal costs–accounting rules and with routinely seeking payment for unallowable costs. The February 5, 2009, IG's report, "Oversight of Design and Engineering Firms' Indirect Costs Claimed on Federal-Aid Grants," focused on the billing practices of designers and engineers under federal grants. Of the 41 firms that were audited, 21 were found to have charged unallowable costs to the USDOT and to state DOTs. The report's recommendations included requiring firms to certify on federally funded cost reimbursement projects that all indirect costs claimed are allowable, and granting state DOTs the authority to assess penalties against firms that claim unallowable costs. Because state DOTs will be the primary vehicles for many infrastructure

projects under the Stimulus Act, the IG's proposed recommendations suggest that audit and enforcement on federal contracts will be strengthened with the flow of Stimulus Act funds, and that state and local contracts funded by the Stimulus Act will experience a level of scrutiny not heretofore seen.

Whistleblower Protections

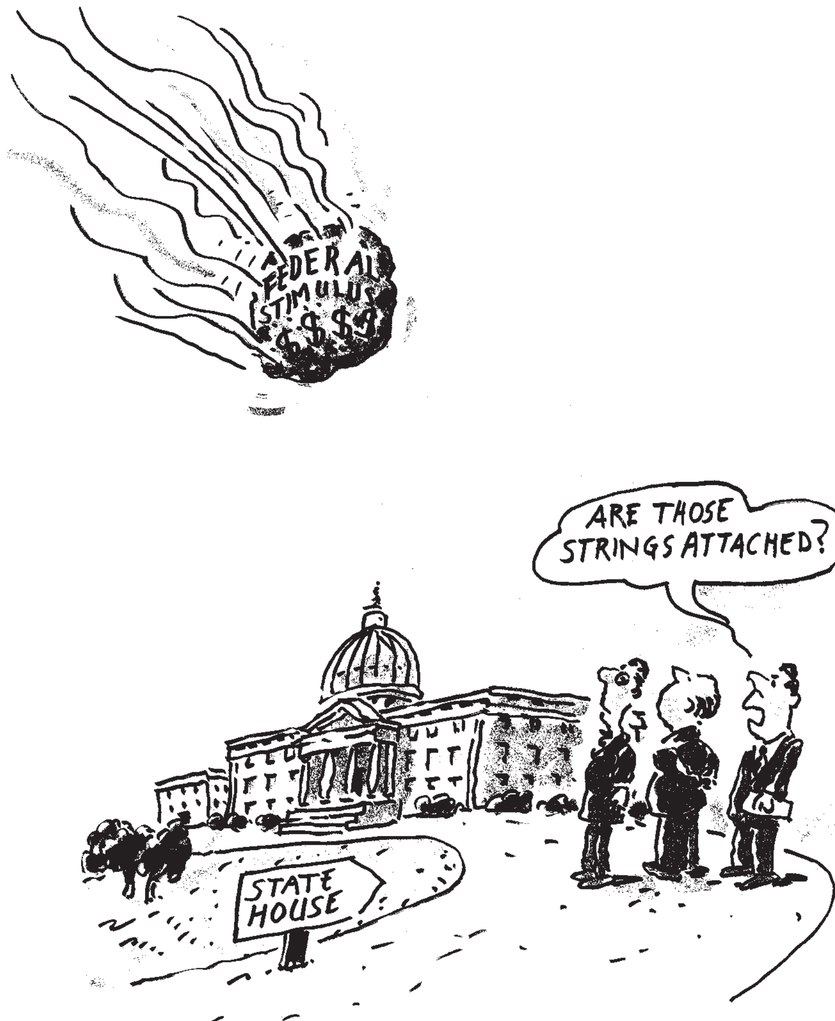
The Stimulus Act also creates protections for state and local government and contractor whistleblowers. This includes anti-retaliation provisions that create a private right of action by a whistleblower against an employer who retaliates against the whistleblower for disclosing gross mismanagement or the waste of Stimulus Act funds, or a violation of a law, rule or regulation related to a covered contact. While the whistleblower protection provisions do not impose civil or criminal penalties against an employer, the Recovery Accountability and Transparency Board is empowered to order an employer to abate the retaliation, reinstate the whistleblower with back pay, and pay all costs and expenses, including attorney fees, incurred by whistleblowers in bringing their complaints.

Is My Risk Being Stimulated?

The Stimulus Act provides a much anticipated and much needed shot in the arm for the construction industry. In staving off the blanket imposition of FAR requirements, the industry can expect the procurement process to operate more smoothly than it would if the Stimulus Act had been enacted as it was originally passed. Nothing in the act fundamentally changes the way public contracting will take place in the U.S. – at the federal, state or local level. For projects funded by the Stimulus Act, federal contractors will continue to be subject to the FAR, and state and local contractors may be subject to elements of the FAR depending on the terms of their contracts or grants and the procurement rules of the state and local agencies with which they have contracts. And ethics laws such as the federal False Claims Act (as well as state and local ethics laws) will continue to apply to contractors.

Given the Obama administration's vow to hold state and local governments accountable for fraud, waste and abuse in the administration and expenditure of Stimulus Act funds, state and local governments can be expected to significantly increase the level of their scrutiny of federally funded contracts. This, coupled with the broad audit and investigative powers that the Stimulus Act gives to federal IGs and the new Recovery Accountability and Transparency Board, will mean that contractors at all levels who engage in business practices that could be characterized as fraudulent will be at risk. For this reason, contractors would be well advised to ensure that their compliance programs are well designed and fully operational for preventing and detecting the types of potential ethics violations that can occur in the business sector or market in which they operate.

William W. (Tom) Thompson and Mark R. Berry,
Partners, Washington, D.C. ■



"Pay-if-Paid" Provision Upheld as Valid by New Jersey Federal District Court

Fixture Specialist, Inc. v. Global Construction, LLC (2009)

A general contractor and its payment bond surety were absolved from any liability to a subcontractor when the owner failed to pay the general contractor (GC), based on a very strong-worded and well-crafted "pay-if-paid" provision in the subcontract. The case is significant for two reasons: (1) it extends the limitation of liability to the general contractor's surety, unlike cases under the federal Miller Act, which do not exonerate the surety notwithstanding the language of the subcontract; and (2) unlike the law in New York and California, such pay-if-paid provisions are not construed to be in contravention of a subcontractor's mechanic's lien rights under the New Jersey Construction Lien Law and, therefore, invalid.

The GC, Global, was constructing a housing project in Princeton, New Jersey. Global subcontracted with Fixture for the plumbing work. Liberty Mutual issued a labor and material payment bond to Global. There was no dispute that the owner, Princeton Junction Apartments, L.P., had not paid Global for its retainage of over $230,000 and for extra work that Fixture performed in the amount of $806,000.

The subcontract contained a provision stating:

> *Subcontractor agrees that Contractor shall never be obligated to pay Subcontractor under any circumstances, unless and until funds are in hand received by Contractor in full, less any applicable retainage, covering the Work or material for which Subcontractor has submitted an Application for Payment. This is a condition precedent to any obligation of Contractor, and shall not be construed as a time of payment clause. This condition precedent also applies to Contractor's obligation to pay retainage.*

The court stated that this provision clearly shifted the risk of owner non-payment to the subcontractor, and did not merely create a "timing mechanism" for payment, something that does not shift the risk and ultimately requires that the general contractor pay the subcontractor regardless of owner non-payment.

In addition, the court rejected the subcontractor's argument that the Construction Lien Law's anti-waiver provision rendered such pay-if-paid clauses unenforceable because they took away the subcontractor's ability to file a lien for work performed. With such a provision, the sub argued, it could never claim in good faith that monies were due and payable. The court relied on the 2000 New Jersey Supreme Court case, *Thomas Group v. Wharton Senior Citizen Housing*, and declined to follow rulings by the highest courts of New York and California, which had ruled that pay-if-paid clauses violated those states' lien laws, and were therefore invalid. The court in *Thomas* had ruled that pre-conditions to payment do not prevent a lien from being filed to preserve lien rights, although foreclosure would be stayed until all the preconditions are met. In short, the court held that the subcontractor could have filed a lien to attempt to receive payment and it would not have been in bad faith notwithstanding the pay-if-paid clause.

Finally, the court agreed that Liberty Mutual, the GC's payment bond surety could avail itself of the pay-if-paid defense because, since its principal, the general contractor, had not incurred any debt, the surety was not answerable to the subcontractor for any obligation.

Charles F. Kenny, Partner, New Jersey ■

<< SIDEBAR >>

The Legal Impact of Climate Change

The Inside the Minds series, from Aspatore, contains chapters by leading lawyers throughout the country regarding their views of how business can prepare for new environmental legislation, especially legislation that relates to green programs and climate change issues. Matt Coglianese's chapter, entitled "Climate Change as a Growing Business Concern," covers both national and global considerations that will undoubtedly play a role in the nature and scope of laws and policies designed to regulate greenhouse gas emissions. Laws and policies of great breadth and application are in the works now, and it makes sense for many industries and businesses to prepare for this wave of change.

An Ounce of Prevention . . .
Proving Your Damages When a Subcontractor Defaults

When a subcontractor defaults, the burdens of a general contractor or construction manager can increase 10-fold. A job that may have been running smoothly is now in disarray. You must quickly engage a replacement subcontractor to keep the project on schedule, to minimize impacts to the other trades and to contain costs. In addition to managing the burdens in the field, you are (we hope) properly documenting the subcontractor's defaults, ensuring that contractually required notices are issued and ensuring that the documentation is in place to prove that the termination of the subcontractor's employment for cause was proper.

In the throes of this flurry of activity, often overlooked is the responsibility that falls to you to plan how you will prove – months, if not years, later – your damages to a judge, jury, arbitrator or mediator, and to the defaulted subcontractor and its attorney. It can be a daunting undertaking, but one that is significantly more manageable and effective if you formulate and follow through on a plan of action leading up to and immediately following the subcontractor's default.

It's All About the Paperwork

Understandably, in the wake of a termination, your primary goal is to replace the terminated subcontractor and successfully complete the project. You must also come to grips with the fact that you now have three additional goals, all of which are equally indispensable. You must prepare to demonstrate: (1) what costs you incurred because of the default; (2) how you incurred those costs; and (3) whether those costs were reasonably incurred. Remember that the subcontractor's defense counsel, its surety and/or your subcontractor default insurer will invariably look to challenge every aspect of your claims. Those seeking to challenge your damages will look to exploit every weakness they can identify in your ability to prove your damages, no matter how legitimate those damages may be. Thus, your focus must be on gathering and packaging the evidence to compellingly prove the integrity of your claims in a court or other hearing.

How best to meet that challenge? Two key functions serve as a good rule of thumb – segregate and document. First, separate out those costs that result from the subcontractor's default from other job costs and then track them in as many distinct categories as possible. Depending on the case, different categories of costs will face different challenges, so dividing them into discrete categories will allow greater flexibility in presenting and defending them to the trier of fact (i.e., the judge, jury or arbitrator).

Assembling detailed documentation, along with short narratives that explain each category of cost and how it ties back to the subcontractor's default, while these costs are being accrued, is an undeniably burdensome process. It is, however, the best shot you have to recover all of your damages and is, without question, less onerous and expensive and vastly more reliable than trying to re-create the details at a later date. In the alternative, we find ourselves faced with trying to parse through piles of documentation years later, with limited assistance from those who lived the experience, as they have moved on to other projects, other employers or other fields altogether. Often, if the effort is not made as the costs are being incurred, the information required to document them is incapable of being re-created after the fact.

To use your staff costs as an important example, you should maintain daily time records that detail how each member of the staff (from assistant field supervisors to general managers) spent his or her time managing problems attributable to the default. Record both the time expended and a narrative description of the tasks performed – every day. By contrast, mere monthly time distribution records, which apportion blocks of time to a project without any real detail, will be challenged on the basis that the records were not maintained contemporaneously and with sufficient detail (even if the records are perfectly accurate).

Imagine yourself on the witness stand. The more compelling that your testimony is regarding the accuracy of your records, the better. Your ability to state that the records were made each and every day, while your memory was fresh, makes your testimony significantly more com-

pelling than testimony that you tried to prepare a statement once a month.

Proving Reasonableness

Give careful consideration to how the completion or correction work will be procured so as to ensure that the costs are demonstrably reasonable. Wherever possible, utilize a competitive bidding process for a defined scope of work and keep clear records of this process to establish that you employed industry-accepted means to secure the best possible pricing.

Make sure you are setting up an apples-to-apples comparison between the defaulted subcontractor's scope of work and that of the replacement contractor. Do not add extra work– i.e. work beyond that which had already been assigned to the defaulted subcontractor – to the initial replacement bidding process.

If you do not take the lowbidder as the replacement subcontractor, document your reasons for this decision (e.g., it missed scope, it withdrew its bid, it was not qualified, etc.). If market forces or project conditions, such as labor shortages or particularly difficult working conditions, drive up replacement or completion costs, document those conditions as well. Years later, when the case goes to trial, if expenditures ballooned because, for instance, skilled workers were scarce, contemporaneous records of such factors would make proving the reasonableness of damages that much easier and more credible.

Extra Work

If extra work materializes during the completion phase that would not have been in the defaulted subcontractor's scope, document it as such, segregate it from the completion work, and – above all – do not try to charge it back to the defaulted subcontractor. This would threaten your credibility on this and all other claims.

If a complete scope cannot be defined for replacement subcontractor/bidders, because you cannot determine the full extent of a defaulted subcontractor's defective or incomplete work without detailed investigation, consider including unit prices in the replacement bid process for as many work elements as possible. If scope grows during the repair or completion work, you will be able to show that the costs were reasonable since they were competitively bid unit prices.

If unanticipated extra work is required of the replacement contractor and it is impractical to competitively bid the work because of the nature of the work or the status of the project, have those elements of the work performed on a well-documented time and material (T&M) basis, again ensuring that you can show that the T&M costs were reasonable under the circumstances.

Occasionally, the replacement subcontractor is required to perform work that is not clearly attributable to the defaulted subcontractor, such as "betterments" to the original design or using a more practical "work around" to fix defective work, as opposed to adhering strictly to the original subcontractor's scope. Whenever the replacement subcontractor is performing work that differs in any way from the original subcontractor's scope, those costs especially should be tracked and documented separately – both material and labor. It may be possible to argue that they were necessary as a result of the default, but having the flexibility of carving them out from other costs provides your lawyer and a judge, jury or arbitrator with critical apportionment options. If the general contractor, which bears the burden of proving its damages, cannot segregate costs attributable to the subcontractor's default from those not attributable to it, you should expect that there will be an effort to deny you all of your claimed damages. Even the most accurate "after the fact" segregation of damages will nevertheless be challenged simply because it was prepared after the fact.

. . . you should maintain daily time records that detail how each member of the staff (from assistant field supervisors to general managers) spent his or her time managing problems attributable to the default.

Schedule-Related Costs

Damages from schedule impacts are especially difficult to track and, thus, especially subject to attack. Delay costs, including extended general conditions and staff costs, and acceleration costs paid to replacement or other trades to make up for delays warrant special planning and attention. Anyone challenging your damages will first look to see if you are trying to attribute every schedule-related issue on the project to the defaulted subcontractor. Ensuring that the schedule's logic is sound, and regularly updating the project schedule with as-built information to show how the subcontractor's default impacted the project, is essential to prove these often significant claims. Using the schedule to demonstrate how acceleration dollars were spent to mitigate delays is equally important. If schedule-related costs are anticipated to be significant, seriously consider engaging the assistance of a schedule consultant through counsel, during the completion work, as here, too, re-creating history is a difficult and costly exercise, with results that will likely be attacked, no matter how accurate.

In Conclusion

Every project and every subcontractor default – is different, and it is, therefore, impossible to provide one foolproof checklist of how to marshal the evidence necessary to prove damages in every case. Each case, with its unique issues, requires individual consideration and planning. You are, however, not alone in this effort. You have a wealth of resources available to any project team in need. Experienced in-house and outside construction counsel, internal and external claims and scheduling consultants, and likely many members of your own organization often have unparalleled depth of experience in this area. Calling in help right from the start can relieve much of the burden from the project team, allowing them to focus on completing the project, and can help avoid the need for the pound of cure.

Gregory H. Chertoff
Partner, New York ■

Musical Chairs:

Which Contractors Get Paid When the Financing SingSong Stops

Notice Requirements to Protect Payment Rights Under California Law

Many contractors are circling 'round and 'round, looking to get paid. Owners sing their songs, this lender or that, this budget or that, this funding or that. Then all the music stops. There are not enough chairs for everyone to sit down, and there is not enough money to pay everyone.

Which contractors are most likely to get paid? Of course, the primary source for payment is the contracting party, owner, general contractor or other entity that promised payment. However, in many instances, the contractors that get paid are the contractors that best protected their project rights (for example, stop notice, mechanics' lien and bond claims) against entities that never directly promised payment. When the promising entity fails to pay, alternative sources of payment become more important.

Now more than at any time in the careers of most living contractors, any and all sources of payment are important, and more likely to be used. Contract breaches are common. Owners, developers, banks and contractors, even sureties, are insolvent and declaring bankruptcies or are in receiverships. As a consequence, for example, on many public projects funded directly or indirectly by the state of California, "suspend work" notices are being issued. On private projects, banks and other lenders are terminating, or reneging on, their financing commitments.

The procedures and timing to protect and prosecute alternative payment rights are various and confusing. To start, the rules differ among private works of improvement, California public works, public works under the California State Contract Act and federal projects, California's entire statutory scheme of project payment rights for contractors has been the subject of reform legislation. Such bills failed in 2008, but they are expected to be renewed, in some form, in 2009.

The starting place to analyze how to identify, protect and prosecute project payment rights is properly classifying what kind of project is at issue. Often, it takes highly educated, trained and experienced persons to correctly analyze these potential rights, and what must be done, when, why and how.

This article addresses one type of event, a "cessation" of work, historically uncommon but increasingly common, which requires a contractor to act to protect and prosecute its potential project rights to payment. Cessation of work is an old legal principle under California law. However, it is not well known. It is an event of which contractors should beware, that should alert them to consult their construction lawyers and to immediately enforce certain project payment rights, or lose such rights forever.

Generally, a cessation of work occurs when all work stops on a project for a continuous period of time. Under California law, for the purpose of setting deadlines to enforce project payment rights, the legal consequence of such a work stoppage can be equivalent to completion of the work of improvement. As briefly outlined below, in California, such work stoppage, a cessation of work, can start the periods

toward deadlines to file notices, record liens or take other legal actions. These deadlines are set as a matter of law, with the same effect but without formal notices such as notices of completion or acceptance or cessation of work.

California Private Works

If neither a completion nor cessation notice has been recorded, the time limit for filing lien claims runs from the date of completion, as defined in California Civil Code Section 3086. Generally, completion of a private work of improvement in California means "actual completion."

However, even when actual completion has not occurred, California Civil Code Section 3086 makes a cessation of work for 60 continuous days equivalent to completion. Therefore, reading California Civil Code Sections 3086 and 3115 together, if there has been no work performed for 60 days and if no notice of completion or cessation has been recorded, the original contractor has 150 days after the 60-day cessation of labor within which to record a claim of lien, generally known as a mechanics' lien.

Moreover, if all labor ceases for any period (for example, even less than 60 days) and if the owner, or owner's agent, occupies or uses the substantially completed work of improvement, there has been a completion under California Civil Code Section 3086(a).

Again, contractors must be careful that there was a complete cessation of labor throughout the continuous 60-day period required under California Civil Code Section 3086(c). Any minor work performed may invalidate a cessation of labor.

California Public Works

On California public works, if there is (1) no notice of completion or notice of cessation recorded; (2) no beneficial occupancy by the local public entity; and (3) no work performed for a continuous 30-day period, under California Civil Code Section 3184(b), contractors have 90 days from the 30th day on which no work was performed in which to file their stop notices.

Under California Civil Code Sections 3098, 3184, 3227, 3247, 3249 and 3252, among others, the time to file payment bond claims is determined from the time within which stop notices must be filed.

California State Contract Act Work

Yet cessation-of-work rules do not apply to contracts subject to the California State Contract Act (California Public Contract Code Sections 10100–10285.5). Generally, the California State Contract Act applies to public works projects under the jurisdiction of the Department of Water Resources, Department of General Services, Department of Boating and Waterways, Department of Corrections and Department of Transportation. However, many state construction projects fall outside these agencies' powers. Again, accurate analysis starts with correctly classifying the work of improvement at issue.

Under the California State Contract Act projects, the time for a contractor to file a claim against a payment bond is determined from the time within which the contractor must file a stop notice. Accordingly, the deadline is not the same. Yet the calculation may rely upon the same analysis whether a cessation of work has occurred.

Conclusion

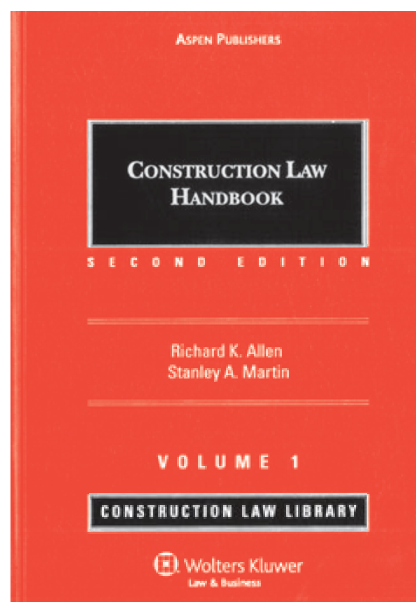
These are perilous times. Now more than ever, construction projects are starting and stopping before completion. If construction projects stop all work long enough, contractors should be aware that they may have project payment rights upon which they must promptly act. Cessation of work is an old legal concept, but it has renewed vitality and application for the vigilant contractor in today's and tomorrow's environment.

Ronald B. Pierce,
Partner, Orange County

<<SIDEBAR>>

Construction Law Handbook, Second Edition, Aspen Publishers, 2009
Chapter 11, "Environmental Issues"

The *Construction Law Handbook, Second Edition*, is a two-volume reference book that is a comprehensive, one-stop reference on the current state of the business of construction and construction law. The second edition contains several chapters that did not exist in the first edition. One of those chapters is Chapter 11, entitled "Environmental Issues," written by Matt Coglianese. The chapter sets out the regulatory framework applicable to major construction projects, highlighting federal and state environmental laws and regulations, and discusses mitigation and allocation of environmental risk on major projects.



N.Y. Court Approves Surety's Right to Settle Claim and Collect from Subcontractor's Principals, Despite Report Finding Subcontractor Not at Fault

HRH Construction v. Fidelity & Guaranty Insurance Company v. Tres, Inc. (2008)

In a decision issued last year, the United States Court of Appeals for the Second Circuit affirmed the decision of the federal district court in a typical case involving a defaulted subcontractor and its performance bond surety.

HRH was the general contractor for a luxury condominium project in New York City. HRH had engaged Tres as its drywall subcontractor. Tres had provided a performance bond issued by FGIC. Tres's performance was deficient mostly because of internal management problems exacerbated by the architect's design errors. Eventually, Tres's lack of progress compelled HRH to issue a notice of default to Tres and FGIC, and subsequently to terminate Tres's subcontract. HRH completed the drywall work and submitted a claim to FGIC under the performance bond. The claim was contested, and HRH commenced a diversity action in federal court to recover its damages. FGIC commenced a third-party action against Tres and its principals under a general agreement of indemnity (GAI). In the course of the litigation, FGIC engaged a consulting firm that issued an expert report concluding that HRH was the party in default. HRH and FGIC eventually entered into a settlement agreement, and FGIC moved for summary judgment against Tres's principals who were liable to FGIC pursuant to the requirements of the GAI. The principals responded with a counterclaim alleging that FGIC had entered into the settlement agreement in bad faith, relying particularly on FGIC's expert report. The district court dismissed the counterclaim on the grounds that the GAI authorized FGIC to settle any right or claim on the basis it considers reasonable under the circumstances in its "sole and absolute discretion," subject only to the requirement that it act in good faith, which was defined as "absence of deliberate or willful malfeasance." The court held that FGIC's expert opinions were not sufficient to show that FGIC acted with deliberate or willful malfeasance when entering into the settlement agreement to avoid what it believed would be costly litigation with the risk of an adverse judgment.

EDITOR'S NOTE >>
The case is important because it shows the discretion given to the surety under a strongly worded GAI to settle claims that are hotly contested by its principals. When we represent a contractor attempting to recover damages under a subcontractor's performance bond, the decision may facilitate settlements. In contrast, when we are representing the defaulted party (either the general contractor or the prime contractor) and its surety is being pressured to settle a claim over our client's objections, the decision may be a negative factor.

Howard M. Rosen, Partner, New York

From Shades of Gray to Black and White:

Revisiting the Subcontract in Tough Financial Times

The current economic climate, straining many businesses and the economy generally, compels general contractors and construction managers to engage in a stricter business discipline than ever before. These times warrant a fresh look at the ways in which business is done so that proactivity provides an advantageous edge. One edge can be honed by a critical review of subcontracts to ensure that they are being used to maximum advantage as a tool to avoid and/or blunt the effects of subcontractor defaults.

Construction disputes thrive in the realm of gray. Parties argue about whether defaults occurred or which party was in default first. Few areas have greater potential for being "in the gray" than subcontractor defaults. Ensuring that your subcontracts contain some key provisions can provide your project teams, lawyers and risk managers the tools to avoid defaults and with opportunities to convert gray to black and white – thereby avoiding protracted disputes.

Three key categories of contract rights are addressed in this article – financial information rights, field operation rights and rights upon default.

Knowledge Is Power– Financial Information Rights

❖ ***Lower Tier Payment Information:*** The subcontract should allow the General Contractor/Construction Manager (GC/CM) to demand a list of *all* subcontractor's lower-tier subcontractors, suppliers and/or union benefit funds on the project. It should empower the GC/CM to contact them at any time to determine whether their accounts receivable are current with the subcontractor. This right should extend to *all* of the subcontractor's projects, whether for the particular GC/CM or otherwise. If the subcontractor is not paying its subs or suppliers on other projects but is current on yours, you will certainly want to know, as that may be a key indicator of what may be coming your way.

❖ ***Creditworthiness Information:*** The subcontract should empower the GC/CM to secure regularly updated financial information from the subcontractor, such as the names of its banks and certification on demand or periodically from both the subcontractor and its bank, that it is current on its loans and has not violated any of the loan covenants. Just like the standard AIA owner/contractor agreements entitle the contractor to reasonable evidence of the owner's ability to finance its obligations, the GC/CM should be entitled to similar evidence of fiscal soundness from its subcontractors.

❖ ***Personal or Parent Guarantees:*** Many of the larger GC/CM firms employ Subcontractor Default Insurance (SDI), in lieu of performance and payment bonds. If a GC/CM is using SDI in lieu of subcontractor bonds, the subcontractor's bonding capacity is not tapped for this project, freeing it for other work and releasing the principals from personal exposure to their sureties. The GC/CM should consider what it can seek in return for this significant benefit– even a limited guaranty from a parent or principal for some portion of the subcontract value can motivate the subcontractor to give your project extra attention.

In addition to providing important financial information enabling risks to be managed operationally, subcontract clauses such as these create the potential for converting gray defaults to black and white ones. If a GC/CM has the contractual right to specific information and the subcontractor fails to provide it or the information provided does not comply with the subcontract's express objective criteria, a default becomes black and white. An easily proved case of subcontractor default is one the subcontractor or its lawyer may think twice before litigating.

Control Is Power– Field Operation Rights

Actively managing subcontractor operations is vital, given the increased significance of a subcontractor default in the current environment.

❖ ***Schedule-Related Clauses:*** Among the grayest areas of defaults are those related to a subcontractor's failure to maintain the progress of its work as required by the schedule. GC/CM clients often ask about default because a subcontractor "does not have *enough* workers in the field," or "does not have *enough* materials on site," or "is not *going to* meet critical milestones," or because the subcontractor "is not working in *all available areas* of the project." Each of these is a subjective statement of a subcontractor's performance or its *anticipated* performance. To avoid disputes, the risk management goal is to convert the subjective

into objective, easily measured successes or failures.

Take a typical scenario – a GC/CM declares a subcontractor in default because based on its current staffing levels in the field, the GC/CM *believes* that the subcontractor *will not* meet an *upcoming* critical performance progress milestone. Thus, after repeated demands for "more" workers, the GC/CM declares the subcontractor to be in default for not timely and properly progressing the work based on this *expectation* that the critical milestone *will be* missed.

The landscape for the subjective, gray dispute has been drawn – the GC/CM has invited the subcontractor to argue that the GC/CM jumped the gun. The subcontractor's lawyer can now argue that the very day after the default, the subcontractor intended to add 20 more workers to the project. Even if the subcontractor was in fact in default, the subcontractor will argue nevertheless that the GC/CM was in default for improperly declaring the subcontractor to be in default before it had a chance to achieve the milestone. The GC/CM counters that it could not wait for the subcontractor to miss the deadline. Now the subjective fight is on, and each side hires lawyers and experts to try to prove what would have happened. Proving the theoretical is always harder, more expensive and less certain than proving what actually happened.

Some planning and foresight, however, should permit the GC/CM to turn the gray to black and white in its favor. The subcontract should permit the GC/CM to require the subcontractor to provide written updates to scheduled operations upon request, including manpower loading by specific areas of the work. If the subcontractor fails to provide the information, that itself is a black-and-white basis for default. If it provides a manpower-loaded schedule and then does not adhere to its manpower commitments, that too is a black-and-white default, avoiding any uncertainty about what would have happened.

❖ ***Delivery Date/Long Lead Item Demands:***
If a subcontractor is struggling financially, it may use what limited funds it has to keep workers in the field, as that is where the GC/CM will look first to monitor progress. Long lead item orders, critical to a project's long-term success, may be delayed or fall by the wayside altogether. Thus, the subcontract should empower the GC/CM to obtain detailed confirmation from the subcontractor regarding these orders and to contact suppliers directly for independent confirmation. The subcontractor's failure to respond to a contractual information demand or a contra-confirmation from the supplier creates the black-and-white default, if necessary.

❖ ***Notice of Claim and Backup Requirements:***
If a subcontractor is going to claim entitlement to extra time or money, or both, the subcontract should require that the subcontractor provide a prompt, detailed notice of its claim with supporting backup. A specific time frame should be provided, such as two or three business days from the date of the event giving rise to the claim, the specifics of the backup required, and a provision that a failure to comply results in a waiver of the claim. These clauses can avoid claims entirely, and when they are presented, permit a GC/CM to defend them on a variety of bases: the waiver clause and the subcontractor's failure to comply prejudiced the GC/CM by depriving it of opportunities to assist and mitigate the claim.

❖ ***Partial Payment Release/Lien Waiver Form:***
The subcontract should include an effective partial payment release/lien waiver form so that the subcontractor agrees up front to the document it will be required to present in exchange for each progress payment. The release language should be comprehensive and should waive *all* claims for payment, extra work, delay, impact, acceleration and the like. Thus, bright lines are drawn with each payment, cutting off all future claims for events that occurred prior to the release.

❖ ***Joint Check Rights:***
Including the right, at the GC/CM's discretion, to issue joint payments to the subcontractor and its lower-tier subcontractors and suppliers, permits the GC/CM to maintain a tight rein on the flow of funds to ensure they get to where they need to go to keep your project moving.

Protections Are Power– Default Rights and Downside Risk Management

One of the greatest risks in declaring a subcontractor default is the potential to be found by a court or arbitrator to have done so wrongly and, thus, for the GC/CM itself to be found in breach of the subcontract. "Wrongful" termination can take two forms, procedural or substantive. Procedural failures relate to a failure to properly implement the default, such as a failure to adhere to the subcontract's notice provisions. Substantive failures relate to the ultimate determination as to whether the underlying claims of default are proven. A misstep in either category may have the same result – instead of the GC/CM recovering its damages from the subcontractor, it may be found in breach of contract itself and be exposed to damages to the subcontractor.

Thus, the subcontract should limit a GC/CM's procedural obligations, maximize its rights against the subcontractor and include protections to manage its downside risk if it is ultimately found to have been in the wrong.

❖ ***Short Notice Provisions:***
Subcontracts often require the GC/CM to give multiple notices to the subcontractor and/or opportunities to cure, prior to declaring a default and/or terminating the employment of the subcontractor. This can delay a default and invites protracted letter writing campaigns between the GC/CM and the subcontractor. An effective default provision permits a declaration of default, followed by a self-effecting termination on short notice without providing an opportunity to cure.

❖ ***Right to Take or Use Materials, Tools and/or Equipment:***
If a subcontractor defaults, re-procurement costs may skyrocket. The ability to utilize the defaulted subcontractor's stored materials, its tools and its equipment may enable the GC/CM to significantly mitigate the costs of completion and to minimize delay. Thus, the subcontract should permit the GC/CM to take and use any materials, tools or equipment of the defaulted subcontractor to complete the work.

❖ ***Cross-defaults and Rights of Setoff:***
Often GC/CM's employ the same subcontractor on multiple projects. The subcontract should provide that if the subcontractor is declared or found to be in default on one subcontract, it may be deemed to be in default on all other subcontracts with that same GC/CM, in the GC/CM's sole discretion. It should further provide that the GC/CM has the right to use monies that may be due to the subcontractor on one project to set off default-related damages the GC/CM may incur on other subcontracts with the same subcontractor. These provisions, of course, should only be employed after securing specific legal guidance, as some jurisdictions preclude the use of such clauses and they may run afoul of trust obligations in some jurisdictions.

❖ ***Right to Proceed While Surety Investigates:***
If a subcontractor is bonded, harmonizing the subcontract's requirements with those of the surety bond requirements is critical to preserving rights under both contracts. The subcontract should contemplate that

when a bonded subcontractor is declared in default and/or terminated for cause, the surety often undertakes an investigation that may delay a GC/CM's ability to engage a replacement subcontractor to complete the work. The subcontract should expressly provide that the GC/CM has the right to engage a completion contractor during the period of any surety investigation to keep the job progressing.

❖ ***Assignment of Lower–Tier Subcontracts:*** The ability to complete the project utilizing the defaulted subcontractor's lower-tier suppliers and subcontractors can often significantly mitigate damages. Thus, the subcontract should include a provision assigning all of the defaulted subcontractor's lower-tier subcontracts to the GC/CM, to be implemented at the GC/CM's sole discretion. These clauses enable the GC/CM to endeavor to compel these lower-tier contractors to continue their performance upon the subcontractor's default, improving the GC/CM's ability to manage the project to completion.

❖ ***Rights to Damages on Default:*** The GC/CM may have a significantly increased managerial workload after a subcontractor defaults and can incur many categories of damages. The default clause should enable the GC/CM to recoup *all* of its costs flowing from the default and should minimize the effort required to prove these damages. In addition to entitling the GC/CM to recover the actual costs of completing or correcting the defaulted subcontractor's work, the clause should permit recovery of *all* direct and indirect costs, including legal expenses incurred in managing the default and re-procuring the work, legal expenses incurred in any disputes with the subcontractor arising from the default, design or other consultant expenses incurred in managing the default or the completion work, and costs incurred to procure extended warranties for the defaulted subcontractor's work, among all other potential damages. Additionally, including fixed percentages for general conditions, overhead and profit, measured against the base damages figures, allows these damages to be efficiently proved by mere mathematical computation, rather than by complicated, detailed proofs of actual expenditures.

❖ ***Termination for Convenience Conversion Clause:*** To manage the downside risk of an improper default (procedural or substantive), two clauses, properly harmonized, should be included in the subcontract. The first is an effective termination for convenience clause, which entitles the terminated subcontractor only to payment for work performed, reasonable overhead and profit on the work actually performed (not overhead and profit on any unperformed work), and reasonable costs of demobilization.

This clause should be coupled with one that automatically converts any termination found to be wrongful into one for convenience. Thus, the GC/CM's worst case is limited to paying the improperly defaulted subcontractor for the work it actually performed.

Rights Secured Today Will Become the Benchmark for Tomorrow's Negotiations

These strained times present challenges and opportunities. The foregoing tools are designed to maximize the opportunities and to minimize the risks of the challenges. Contract clauses that may not have been necessary in boom times are essential for risk management in leaner times. History dictates that such rights, once included in subcontracts, will become the standard against which future negotiations will be measured. Thus, it behooves forward-looking GCs and CMs to consider employing clauses such as these both for the risk management tools they provide now and to raise the bar for future negotiations.

Gregory H. Chertoff
Partner, New York ■

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Charles F. Kenny, Esq., Co-Editor
Michael A. Branca, Esq., Co-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
41 Madison Avenue, 20th Floor
New York, NY 10010
Telephone: (212) 382-0909
Facsimile: (212) 382-3456

San Francisco
455 Market Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 837-1968
Facsimile: (415) 837-1320

Los Angeles
1875 Century Park East, Suite 550
Los Angeles, CA 90067
Telephone: (310) 228-1075
Facsimile: (310) 228-1076

Orange County
20 Pacifica
Suite 260
Irvine, CA 92618
Telephone: (949) 608-3100
Facsimile: (949) 608-3103

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

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

Washington, D.C.
Two Lafayette Centre
1133 21st Street, N.W.
Suite 500
Washington, DC 20036
Telephone: (202) 293-8815
Facsimile: (202) 293-7994

Chicago
209 South La Salle Street, Suite 1660
Chicago, IL 60604
Telephone: (312) 881-6300
Facsimile: (312) 435-2482

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

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