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The Basics of Subcontractor Defaults – Key Considerations

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The success of general contractors in completing a construction project is often dependent upon the performance of their subcontractors. General contractors have frequently said exactly this. Traditionally, the key subcontractors on a project are the electrical, plumbing, HVAC and structural steel subs. Due to the fundamental nature of the work performed by these trades, the risk of defaulting and terminating one or more of them is likely to have a substantial impact on the project, more so than with the trade contractors that perform their work after a building is made weather tight (i.e., drywall, tile, painting).

Most general contractors have, over a period of years, established longstanding relationships with certain subcontractors that they have come to depend upon. The risk of having to default and terminate one of these subs is minimal. Nevertheless, there will inevitably arise occasions when even a once reliable subcontractor fails to perform and it becomes necessary to invoke the remedies of default and termination. Areas ripe for controversy with subcontractors that often can lead to default and termination often involve disputes over change orders and the scope of work, the installation of defective work and the back-charges that ensue therefrom, and, to a lesser extent, conflicts that arise from ambiguous plans and specifications and the extra work and delays caused by the discovery of unforeseen site conditions.

Preparedness is Essential

The old adage that an ounce of prevention is worth a pound of cure is especially appropriate when it comes to subcontractor disputes. General contractors will want to be in the best position possible in the event they have to default and terminate a sub. When this occurs, the general contractor's first line of defense is a well written subcontract agreement that clearly spells out both parties' rights and obligations. Therefore, when preparing the document, attention should be paid to clearly defining the scope of work. Also, since time is money on a construction project, equally important is the identification of key project milestones for the completion of critical items of work. Incorporation of a liquidated damages provision should also be included, especially if the prime contract with the owner contains a liquidated damages provision that can be invoked against the general contractor if one of their subs fails to perform.

Effective subcontracts between general contractors and their subs should have a number of additional key features, including:

- A “flow-down” provision, passing through to the subcontractor all of the obligations that the general contractor has agreed to in its prime agreement with the owner;
- A provision that states that compensation for extra work or delay claims will be paid only to the extent the owner deems such work to be “extra”. (This is important because most prime contracts routinely have stringent provisions limiting compensation for extra work and delay type damages.);

- Incorporation by reference into the subcontract all the terms and conditions of the prime contract between the general contractor and the owner.

When Problems Arise

There are several red flags portending a subcontractor's poor performance that general contractors need to pay attention to. These include:

- the failure to properly staff the project;
- premature demands for money;
- lien claims from suppliers or vendors;
- service of writs of attachment based upon judgments entered against the subcontractor;
- delinquent tax notices or levies;
- notices of deficiencies from union funds and the state Department of Labor;
- requests for joint check agreements;
- baseless change orders and requests for additional compensation; and
- the filing of bankruptcy.

Defaulting and terminating a subcontractor ultimately becomes an exercise in minimizing risk and maximizing reward. Minimizing risk entails ensuring that no further sums will have to be paid to the subcontractor due to an adverse court decision or arbitration award. Maximizing reward involves recovering money from the subcontractor as compensation for any additional costs that have been incurred. General contractors can help themselves to minimize risks and maximize rewards by consistently documenting all project events while the subcontractor is performing its work on the project. The fact is that most construction disputes boil down to who has created the best "paper trail."

In addition, with subcontractor disputes general contractors stand in a precarious position, because they are stuck square in the middle of trying to appease a project owner while at the same time protecting themselves from subcontractor claims. As such, general contractors must perform a careful balancing act by successfully documenting its case against the subcontractor, while simultaneously taking care that the information generated does not become ammunition for the owner in any disputes that may arise with the owner. This is not always a simple task.

Consider the following suggestions:

- When general contractors are documenting a case against a subcontractor, it is best to keep the tone of your written record professional, concise and simple. This is not a time for creating documents full of explosive adjectives that berate a subcontractor's performance;
- Correspondence should recite the pertinent contract provisions and clearly indicate key facts and dates. It is important to create an accurate, contemporaneous record of the subcontractor's performance on the project, because a dispute with a subcontractor may not be resolved until far into the future;
- In today's world of electronic transmissions, there is often a tendency for emails to be written as if the writer is having a conversation with the intended recipient, with little attention being paid to

detail and the ramifications of what is being stated. Simply put, emails that document the poor performance of a subcontractor should be written with the same level of attention and detail as if they are formal letters;

- More specifically and as a general rule, documentation confirming the poor performance of a subcontractor should answer the following questions: (a) what transpired; (b) when it occurred; (c) how the general contractor responded; and (d) confirm factually the circumstances surrounding the issue.

Keeping these points in mind will create an evenhanded and valuable record of events without putting the general contractor in harm's way with the owner.

Subcontractor Termination

Preparing a well-documented record also serves the purpose of having a record to support the proper termination of a subcontractor. In the event it does become necessary to terminate, it is imperative that the termination provision of the subcontract be assiduously followed. By doing so it minimizes the chances of the subcontractor successfully mounting a claim for wrongful termination, which can lead to an award of punitive type damages. To the extent your subcontract gives the subcontractor an opportunity to cure its default, the opportunity must be provided to the subcontractor. Remember, as a basic legal principle, all parties to a dispute have a right to minimize their potential damages. If the subcontractor does not avail itself of the opportunity to cure, a termination letter should be issued in accordance with the terms of the subcontract. If the subcontractor is bonded, a copy of the default notice and termination notice must be provided to the surety. At the time of termination, an accurate written record should be made of any incomplete and/or defective work, supported by photographs and video. To the extent that defective work needs to be corrected, the work should not be removed until the subcontractor is given an opportunity to inspect it. This prevents later allegations of spoliation of evidence. In order to recover any losses that may be sustained in completing a subcontractor's work or repairing defective work, documentation will be needed to support such a claim, including:

- Identification of separate work events;
- Daily reports prepared contemporaneously specifying the tasks performed and confirming the manpower employed with hours expended;
- Confirmation of how costs are kept, tracked and coded; and
- Back-charges

Forums

It is not uncommon after a default and termination of a subcontractor for the parties to wind up in a lawsuit. However, the forum in which such disputes will be decided is frequently not given proper consideration during subcontract negotiation. The likely reason is that the parties want to be cautious about sending a hostile signal even before work on a project has commenced. While such thinking is understandable, it is a mistake. A decision should be made whether the dispute should proceed in a court of law or an arbitration. Both forums have their pros and cons.



Proceeding in a court of law provides the parties with such benefits as the right to discovery, including depositions, and the right to appeal in the event they are not happy with the decision rendered by the court or a jury. Filing fees in court proceedings are also relatively low. If the dispute is heard by a judge, without a jury (i.e., bench trial), it is not likely that the judge hearing the dispute will have any special knowledge concerning construction or construction law. This is even more likely in a jury trial. In fact, there are very few positives to having a jury hear a construction dispute. Most construction disputes are complex, involve technical issues, and have protracted hearings that are typically accompanied by days of testimony and volumes of exhibits. Jurors will likely become confused by the morass of paper, testimony and conflicting stories that often occur during the trial. Also, juries can also be swayed by a sympathetic story that has nothing to do with the merits of a dispute and jury verdicts provide very narrow grounds for appeal and are very difficult to overturn. Moreover, litigation in court can drag on for years.

For all these reasons, some contractors have turned to the use of private arbitration. Arbitrations are typically heard by an experienced arbitrator or panel of arbitrators that have construction experience. While not inexpensive, arbitrations do provide for a speedier remedy in a less formal setting, where the rules of evidence are not strictly applied. The downside of arbitration is that there is limited paper discovery, usually no right to depositions and limited rights to appeal if you are unhappy with the arbitration award. Arbitration awards are also nearly impossible to have set aside. That said, many construction disputes are arbitrated.

Considering all of the pros and cons of either arbitration or court resolution, consider the selection of forums in the following order: (1) arbitration, (2) litigation in court via bench trial without a jury, and (3) litigation with a jury (perhaps the least desirable forum).

Conclusion

General contractors walk a fine line when balancing their relationships with owners and subcontractors in order to effectively deliver projects on time and within budget. It is important to keep in mind the aforementioned points in order to meet this goal. Implementing these strategies will facilitate successful project completion and the best possible outcome for your business.

