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Bankruptcy: Payment to Lower-Tier Contractors Outside of Debtor's Estate

by Danielle Cohen

When a party in a construction dispute declares bankruptcy, the natural reaction is to assume a downstream client's recovery will be limited to pennies on the dollar, if anything. However, where the property owner or general contractor is withholding money from the bankrupt party, those funds may fall outside of the bankruptcy estate, leaving open the opportunity for an unpaid subcontractor or supplier to be paid, separate and apart from the bankruptcy.

A bankruptcy estate is created at the time the bankruptcy petition is filed. The debtor's estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."[1] A legal interest is an ownership interest that is recognized by law (*i.e.*, a bankrupt general contractor's title to construction equipment). An equitable interest is where there is no legal interest, but in fairness the debtor should hold an interest in the property (*i.e.*, an individual holding title to construction equipment that is used by the bankrupt general contractor).

Where, at the commencement of the bankruptcy action, the debtor only holds legal title, and not an equitable interest, that property only becomes part of the bankruptcy estate to the extent of the debtor's legal title to the property, but not to the extent of any equitable interest the debtor does not hold in the property.[2] In other words, monies to which a subcontractor or supplier has an equitable interest may never become property of the estate. The court, when determining if the property is part of the debtor's estate, will examine state law to determine if a property right exists.[3] In New Jersey, while the outcome may be the same, the analysis is slightly different, depending on whether the project is private or public.

On a public project, the money paid from the public entity to the general contractor constitutes a trust fund for the laborers and materialmen on the project.[4] While the general contractor debtor may have a legal interest to the funds due on a public project, to the extent any subcontractors have not been paid and have filed liens, the bankrupt general contractor does not have an equitable interest in those monies. Therefore, trust funds do not become property of the debtor's estate and can be used by the public entity to pay unpaid subcontractor lienors outside of the bankruptcy.[5]

While monies owed by owners to general contractors on private projects are not statutory trust funds in New Jersey, an argument can also be made that the monies due and owing to unpaid subcontractor lienors are outside of the debtor's estate. When unpaid subcontractors file a construction lien claim, a *lien fund* is created, comprised of the monies owed to the general contractor for work that has been performed. An argument can be made that the subcontractor lienor has rights to that lien fund that are superior to the general contractor, and that the monies that make up the *lien fund* never become part of the debtor's estate.

The New Jersey courts have held that "[a] contract right becomes an account as performance is made under the contract."[6] General contractors have a contractual obligation to pay their subcontractors. Therefore, payment to subcontractors would be a condition precedent to a general contractor receiving payment from the owner. Where the contract is not performed, nothing comes into existence upon which there could be any attachment, as the general contractor would not be entitled to any contract proceeds.[7] In other words, if a bankrupt general contractor failed to uphold his contractual obligations by failing to pay subcontractors, and ensuring that the property is free and clear of any liens, there is arguably nothing due and owing to the general contractor under the contract to become part of the debtor's estate.

While the court has previously determined that payments held by a public entity are not part of the bankrupt's estate due to statutory trust funds,[8] the bankruptcy court has extended this concept to private projects on contractual grounds.[9] More specifically, the bankruptcy court held that where a contract is breached by the bankrupt party's failure to pay its subcontractors, it was not owed any money under the contract and, therefore, those funds are not part of the debtor's estate.[10]

An unpaid subcontractor lienor's rights may even be superior to another party's security interest in the debtor's accounts receivable. Where a party, such as a bank with a Uniform Construction Code (UCC) lien, has an interest in the debtor's accounts receivable, the interest is no greater than that of the debtor.[11] Therefore, the party with a security interest would only be entitled to payment of any balance remaining, if any, after the interests of the unpaid lienor are satisfied.[12]

In sum, the filing of a bankruptcy petition does not necessarily result in subcontractors and suppliers' inability to recover what they are due. Where an unpaid subcontractor or supplier has filed a lien claim, the monies due from the owner to the bankrupt general contractor are likely not part of the debtor's estate. It is also possible that monies due to an unpaid subcontractor or supplier who has not filed a lien claim will not be property of the debtor's estate and, therefore, these unpaid parties will be able to seek payment outside of the bankruptcy.

If a subcontractor or supplier is owed money from a bankrupt party, and there is money being held by the entity with whom the bankrupt party has contracted, the best course of action is to file a motion with the bankruptcy court for a determination that the monies are outside of the bankruptcy debtor's estate.

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Endnotes

1. 11 U.S.C. § 541(a)(1).
2. 11 U.S.C. § 541(d).
3. *Bezner v. United Jersey Bank (In re Midway, Inc.)*, 166 B.R. 585, 590-591 (Bankr. D.N.J. 1994). (internal citations omitted).
4. N.J.S.A. 2A:44-148; *Montefusco Excavating & Contractor Co. v. County of Middlesex*, 82 N.J. 519, 525 (1980).
5. *Montefusco Excavating & Contractor Co. v. County of Middlesex*, 82 N.J. 519, 525 (1980); *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962).
6. *Continental Finance, Inc. v. Cambridge Lee Metal Co.*, 100 N.J. Super. 327, 340 (Law Div. 1968).
7. *See Damato v. Leone Contr. Co.*, 41 N.J. Super. 366 (App Div. 1956); *United States v. Commonwealth of Pa. Dept of Highways*, 349 F. Sup. 1370 (E.D. Pa. 1972).
8. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962).
9. *First Indem. of Am. Ins. Co. v. Modular Structures (In re Modular Structures)*, 27 F.3d 72 (3d Cir. 1994).
10. *Id.* at 79.
11. *Bezner v. United Jersey Bank (In re Midway, Inc.)*, 166 B.R. 585, 588 (Bankr. D.N.J. 1994).
12. *Id.*

Inside this issue

The opinions of the various authors contained within this issue should not be viewed as those of the Construction Law Section Newsletter or the New Jersey State Bar Association.

Vincent Pools, Inc. v. APS Contractors, Inc.: Maximizing the Ability to Recover on Public Works Contracts

by Paul Fader and Dorthy Koncur

Those representing general contractors and subcontractors who perform services or provide material in connection with public works contracts are generally aware of the avenues for recovering unpaid funds in connection with public works contracts. The Public Works Bond Act,[1] the Trust Fund Act,[2] and Municipal Mechanic's Lien Law[3] (MMLL) provide certain statutory protections for those who supply labor or materials on public works projects. The Public Works Bond Act requires the general contractor for a public agency contracting public works projects to furnish a bond in order to ensure payment for the performance of labor and supply of materials. The Trust Fund Act mandates that when payments are made to a general contractor, those sums constitute a trust in favor of unpaid material suppliers and laborers. The trust then attaches to monies paid by the public agency to the hands of the general contractor. The MMLL protects an unpaid subcontractor by enabling it to claim against monies due to the general contractor payable by the public agency.

A recent decision by the New Jersey Appellate Division reiterates that these three statutes should be read cumulatively, and that recovery under one does not necessarily preclude recovery under any of the other statutes.

In an unpublished Appellate Division decision, *Vincent Pools, Inc. v. APS Contractors, Inc.*,[4] a subcontractor initiated a lawsuit to collect the balance due for work performed on behalf of the general contractor in connection with the installation of plaster work on a municipal pool project in Jersey City. After the subcontractor completed performance, Jersey City contended the quality of the plaster was defective, and demanded the general contractor remove and correct the work. The general contractor refused, and instead offered to acid wash the pool. Thereafter, Jersey City terminated the contract with the general contractor. Jersey City asserted termination was appropriate and contended it had satisfied its payment obligations to the general contractor for the work completed on the pools prior to the termination. Nevertheless, Jersey City conceded it did not pay the general contractor for certain outstanding change order work requests and, in turn, the general contractor withheld that amount from the subcontractor. Consequently, the subcontractor resorted to filing a municipal mechanic's lien against the project funds due and owing from Jersey City to the general contractor, and a lawsuit seeking, in relevant part, the enforcement of its municipal mechanic's lien against Jersey City.

Procedural History

At trial, the jury rendered a verdict in favor of the subcontractor on the municipal mechanic's lien claim in the amount of $150,498.92. The jury also awarded $502,966 to the general contrator on its cross-claim against Jersey City. However, the trial judge reduced the general contrator's judgment to $352,467 in order to deduct the amount previously paid by Jersey City to the general contrator for the portion of the contract due to the subcontractor. On appeal, Jersey City contended the trial court's decision amounted to a double payment to the general contractor for the subcontractor's work, because the general contractor already received the full amount of the funds appropriated for the project.

The Decision

The Appellate Division noted that a lien filed under the MLLL is limited to the amount owed by the public agency to the general contractor at the time the lien is filed, or what becomes due under the prime contract thereafter. The MLLL also pertains to the full amount of the public contract as the amount to which a lien may attach, and not just the amount that may be allocated to a specific portion of the contract. Therefore, the fact that Jersey City still owed funds to the general contractor on the contract and the change orders pertaining to the entire project—not just the subcontract scope of work performed by the subcontractor—entitled the subcontractor to lien against the funds remaining in the hands of Jersey City that were due and owing to the general contractor at the time the lien was filed.

The Appellate Division noted that Jersey City did not double pay for the subcontractor's work since the trial court judge reduced the general contractor's award to offset the amount Jersey City previously paid in connection with the plastering services. Accordingly, the Appellate Division affirmed the trial court's decision with respect to the subcontractor's lien claim. The court noted that the availability of alternative remedies pursuant to a claim under another statute, such as the Trust Fund Act, did not negate Jersey City's exposure under the MMLL. The ability to obtain relief pursuant to one statute does not preclude recovery under a different statute.

Conclusion

The *Vincent Pools* decision is critical for practitioners representing general contractors and subcontractors who perform services or provide material in connection with public works contracts because it illustrates how filing a valid lien claim under the MMLL provides an avenue for protection when attempting to obtain payment. Public owners may not shield themselves from their obligations to subcontractors simply by asserting that payment for the subcontractor's scope of work has already been made. Any funds remaining and owing to the general contractor for the project as a whole are subject to a valid lien claim.

Counsel should be cognizant of the applicable requirements under the Public Works Act, the Trust Fund Act, and MLLL, and take action to preserve and maximize their clients' ability for recovery. ■

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Endnotes

1. N.J.S.A. 2A:44-143 *et seq.*
2. N.J.S.A. 2A:44-148.
3. N.J.S.A. 2A:44-125.
4. 2015 WL 10489978/2016 N.J. Super. Unpub. LEXIS 595 (N.J. Super. Ct. App. Div., March 18, 2016).

Bidder's Experience and Prequalification Requirements: Pay Careful Attention

by Adrienne L. Isacoff

State agencies and local contracting units have the authority to establish qualification requirements for undertaking the performance of public works projects. Bidders must carefully review the requirements and provide as complete information as possible, or risk bid rejection.

State Requirements

On the state level, bidders are required to furnish "a statement under oath in response to a questionnaire, standardized for like classes of work...to develop fully the financial ability, adequacy of plant and equipment, organization and prior experience of the prospective bidder...."[1] The state then classifies prospective bidders regarding the character and amount of public work on which they are qualified to submit bids, and bids may only be accepted by state agencies from persons qualified under this process.

The procedures for the classification process are undertaken by the Department of the Treasury, Division of Property Management and Construction (DPMC), which classifies prospective bidders based on their past performance record for a variety of trades, from generic (such as C008 General Construction) to specific (such as C117 Underground Storage Tanks). Bidders seeking classification must identify at least two projects for each requested trade that were performed within the past five years.[2]

Other state agencies, such as the Schools Development Authority, rely in part upon the DPMC classification system when soliciting bids, but a further review process is undertaken. Even contractors already classified by DPMC are required to fill out the School Development Authority (SDA) prequalification application, which is reviewed for completeness and then forwarded to the New Jersey State Police for a "moral integrity screening."[3]

New Jersey Department of Transportation has its own prequalification system.[4] Potential bidders must be classified and have a project rating in order for their bids to be opened. Contractors must apply for prequalification using the questionnaire on Form DC-74A, which requires, among other things, a classified certified public accountant (CPA)-certified audited financial statement or a classified CPA-reviewed financial statement in accordance with general accepted accounting principles; statements regarding construction equipment owned, key personnel, prior experience, and work record; and a statement that the contractor has adopted an affirmative action program for equal employment opportunity in accordance with federal and state laws.

Local Requirements

On the local level, the Public Schools Contracts Law (PSCL), N.J.S.A. 18A:18A-26, provides that all prospective bidders "*shall* first be classified...as to the character and amount of public work on which they shall be qualified to submit bids." Boards of education rely on DPMC classification for this qualification protocol.[5] That provision was revised in 1999 to shift reliance for the classification system to the DPMC, whereas previously the State Board of Education was permitted to adopt regulations for that purpose.

The Local Public Contracts Law (LPCL), N.J.S.A. 40A:11-1 *et seq.*, has a different mechanism than the PSCL. There is no mandatory requirement in the LPCL for prospective bidders to be qualified. N.J.S.A. 40A:11-20 provides that there *may* be required from any bidder submitting a bid a certificate showing that the bidder owns, leases or controls the necessary equipment required by the plans and specifications. Other than that provision, the only section of the LPCL relating to qualification of bidders is N.J.S.A. 40A:11-25, which provides that the contracting unit "may establish reasonable regulations appropriate for controlling the qualifications of prospective bidders...by the class or category of goods or services to be provided or performed, which may fix the qualifications required according to the financial ability and experience of the bidders and the capital and equipment available to them pertinent to and reasonably related to the class or category of goods and services to be provided or performed...."

Importantly, a contracting unit must hold a public hearing prior to the adoption of any such regulations and, after the hearing, must submit the proposed regulations and transcript of the hearing to the director of the Division of Local Government Services (DLGS) for the director's approval. DLGS may disapprove the proposed regulations if it finds they will unnecessarily discourage full, free and open competition; restrict the participation of small businesses in the public bidding process; create undue preferences; or otherwise violate the LPCL.

Finally, N.J.S.A. 40A:11-25 provides that local governing bodies may adopt a standard form of statement or questionnaire for bidders on public works contracts "and, in such case, their action shall be governed as provided herein."

The DLGS brought this statutory provision to the attention of local contracting units by issuance of Local Finance Notice 2016-12, which stated that "[a]bsent Director approval, bid prequalification regulations are of no force and effect and may not be required as a condition of bid acceptance on any public contract." The director may approve prequalification requirements for a set number of years, not to exceed five years, or only for the duration of a specific project.

The question remains whether local contracting units may require evidence of 'responsibility' of bidders, since the LPCL provides that contracts shall be awarded to "the lowest *responsible* bidder."[6] 'Responsible' is defined as "able to complete the contract in accordance with its requirements, including but not limited to requirements pertaining to experience, moral integrity, operating capacity, financial capacity, credit, and workforce, equipment, and facilities availability."[7]

Since the LPCL does not mandate that local units adopt regulations regarding qualification, many, if not most, governing bodies have not engaged in what they may consider to be the somewhat onerous proceedings set forth in N.J.S.A. 40A:11-25. The burdensome nature of that statutory requirement is acknowledged in the leading treatise on New Jersey public bidding requirements, which characterizes them as "usable in those situations where major construction is involved and in which prequalification...is thought desirable."[8]

Rather than use this optional procedure, local units either provide in their specifications that bidders must be prequalified for certain trades by DPMC, or require that bidders provide evidence of financial capacity, equipment and facilities, and experience evidencing their capacity to undertake the scope of work set forth in the plans and specifications. Through those requirements set forth in the specifications, contracting units determine whether the bidders are 'responsible.'

These types of financial and experience requirements have uniformly been upheld by the courts, without having to go through the N.J.S.A. 40A:11-25 procedures for adopting regulations. For example, in *P & A Const., Inc. v. Tp. of Woodbridge*,[9] the court found the requirement that a bidder submit a certified financial statement is a material and nonwaivable bid element. In *Vanas Const. Co. v. City of Jersey City*,[10] the court noted that financial security is only one factor that evidences the bidder's ability to perform the contract. In fact, the court overruled the municipality's decision to waive requirements for bidders to submit certificates of experience and questionnaires from subcontractors, notwithstanding that there is no statutory requirement for such experience certificates to be submitted on behalf of contractors.

Best Practices

Whether the directive by the DLGS has ripple effects on these types of 'responsibility' requirements by local governing units remains to be seen. For the time being, bidders should be careful to review whether the bid specifications require DPMC prequalification or simply evidence of experience and other capacity to perform the project. And, of course, if one is seeking to knock out the numerically low bidder, it is important to review their conformance with those requirements, as well.

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Endnotes

1. N.J.S.A. 52:35-2.
2. N.J.A.C. 17:19-2.4.
3. N.J.S.A. 18A:7G-1 *et seq.* and N.J.A.C. 19:38A.
4. N.J.S.A. 27:7-35.1 *et seq.* and N.J.A.C. 16:44-3.1 *et seq.*
5. N.J.S.A. 18A:18A-27.
6. N.J.S.A. 40A:11-4 (emphasis added).
7. N.J.S.A. 40A:11-2(32).
8. 35 N.J. Prac., Local Government Law § 15:25 (4th ed.).
9. 365 N.J. Super. 164 (App. Div. 2004).
10. 2010 WL 5185088 (N.J. Super. Ct. App. Div. 2010).

The Basics of Controlled Insurance Programs

by Gary Strong

Controlled insurance programs (CIPs), also referred to as wrap or wrap-up insurance, refer to project-based insurance programs designed broadly to cover the project-related risks and losses of all program participants. CIPs have been growing in use across the country, so familiarity with their intricacies is important in complex construction cases.

Participants in a CIP typically include the project owner or developer, the general contractor/construction manager, subcontractors, architects and engineers. Coverage provided through a CIP may include workers' compensation, employers' liability, general liability, builders' risk, property, auto, pollution and environmental. CIPs often will not include coverage for professional liability, and small subcontractors, vendors or suppliers are frequently not included as program participants.

A CIP replaces individual coverages provided by the project's participants and, instead, is sponsored either by the owner (OCIP) or a primary contractor (CCIP). Rather than requiring subcontractors and lower-tier participants to acquire and pay for their own insurance and name the owner and general contractor as additional insureds, the owner or general contractor sponsors the CIP and requires the necessary participants to buy into that program. The participants in a CIP are typically identified as named insureds, but some covered individuals or entities may also be covered under a broadly defined category of insureds.

Who is Covered?

Typically, in the OCIP, the owner is the first named insured, but the general contractor, subcontractors, consultants and subconsultants of every tier are also named insureds. In a CIP, the general contractor is usually the first named insured and named insured status is extended to subcontractors, consultants, and subconsultants of every tier. Some experts advise that the owner should be merely an 'additional insured,' not added as a 'named insured,' in a CIP, in part, so the owner cannot extent 'additional insured' status to others.[1] However, this can introduce a host of additional insured issues that are best avoided. Many CIPs, therefore, include the owner as a named insured.

A typical OCIP named insured endorsement may provide:

> NAMED INSURED ENDORSEMENT (OCIP)
>
> *This endorsement modifies insurance provided under the following:*
>
> COMMERCIAL GENERAL LIABILITY INSURANCE FORM
>
> Policy Declaration, "Names Insured" is amended to include as Named Insureds:
>
> All contractors and/or subcontractors/consultants and/or subconsultants for whom the Owner or Owner's agent are responsible to arrange insurance to the extent of their respective rights and interests.
>
> Coverage afforded by this policy is automatically extended to contractors who are issued a Workers' Compensation policy under this Owner Controlled Insurance Program (OCIP). All other contractors not issued a Workers' Compensation policy must be endorsed onto the policy to be afforded coverage under this policy.
>
> "Named Insured" does not include vendors, installers, truck persons, delivery persons, concrete/asphalt haulers, and/or contractors who do not have on-site dedicated payroll.
>
> All other terms, conditional and exclusions remain the same.

This endorsement extends named insured status only to those subcontractors/consultants or subcontractors for whom the owner or the owner's agent are responsible to arrange insurance *and* to whom a workers' compensation policy has been issued. This does not mean everyone who may be onsite.

Excluded contractors and activities often include some or all of the following: security guards; suppliers; vendors; material dealers; truckers; haulers; sometimes design consultants and subconsultants; subcontractors with scopes of work less than $10,000, $15,000, or some other amount; and others with little or no onsite payrolls. The rationale for excluding these entities is that CIP coverage should not be provided to parties whose work and safety is not controlled by the CIP.

CIP coverage is typically limited to onsite risks, losses and casualties. Particularly given modern construction practices, determining whether an accident is an onsite or offsite loss may not be straightforward. For example, steel assemblies or subassemblies may be specially manufactured and then brought onsite for final assembly and installation.[2] Difficulties can also arise from ambiguous descriptions of the covered project site. The contract documents, the CIP manual, and the policies must define the 'project site' in the same way. If the CIP endorsement refers only to a street address, it can be difficult to determine if coverage includes access roads, adjacent lots, staging areas, storage areas, project offices, trailers, parking areas, etc.

Even if the initial CIP policies provide comprehensive coverage for the project site, appropriately defined, because many projects continue for several years, the CIP participants run the risk that sometime during this period one or more CIP insurers may cancel, refuse to renew, or materially change their policies. If this happens, the other participants need to be sure they are promptly notified of the change and that notice is not be limited to the sponsor, as the first named insured. Otherwise, they can have a nasty surprise when a claim arises. Insurers are not likely to agree to provide such notice to all participants, but they sometimes will agree to provide notice to both the owner and the general contractor. In any event, the sponsor and the CIP administrator can be required to provide such notice.

Benefits and Risks of a Controlled Insurance Program to Contractors and Subcontractors

The primary benefit of wrap-up insurance to contractors and subcontractors is that it allows them to work on projects they might otherwise not be able to properly insure. Furthermore, general contractors can sometimes obtain CIP at a lower total project cost than conventional insurance programs in which insurance costs are included in every subcontractor's bid. This can provide a competitive advantage to a general contractor bidding on new projects.

In recent years, a greater proportion of projects are going into CIPs.[3] A wrap-up CGL insurance policy can also provide broader coverage for the construction team in terms of environmental risks. The additional cost of a program administrator is often less than the costs of having to monitor the myriad of insurance certifications, additional insured endorsements, renewals and premium audits that accompany traditional multiple liability insurance policies for each of the project participants.[4]

The primary risks for contractors and subcontractors are that the coverage afforded under the wrap-up CGL insurance policy will have gaps and will not cover them sufficiently for future losses. Contractors need to exercise diligence in screening coverages afforded under a proposed OCIP.[5] Similarly, subcontractors need to carefully review the provisions of any proposed OCIP of CIP before bidding. If insufficient information is provided in the invitation to bid, subcontractors should qualify their bid. Subcontractors need to be particularly aware of 'rolling wraps,' or CIPs that cover more than one project. Under a rolling wrap, there is a risk that the rolling wrap-up insurance policy could be depleted by losses on other projects.[6]

Duration of the CIP

Usually a CIP continues until project acceptance by the owner or the project is 'complete.' Setting aside 'completed operations' coverage, which is discussed below, such termination provisions can be problematic. It is not always clear when a project, or a portion of it, will be deemed complete. Standard general liability policies often provide that "Your Work" will be deemed completed at the earliest of the following times:

> When all of the work called for in your contract has been completed.
>
> When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
>
> When that part of the work done at a job site has been put to its intended use by a person or organization other than another contractor or subcontractor working on the same project.
>
> Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as complete.

Other policies may have similar provisions, or may also deem the project complete whenever a temporary or permanent certification of occupancy is issued.

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Endnotes

1. Tracey Alan Saxe, Construction Wrap-Ups: Owner and Contractor Controlled Insurance Programs, *Construction Law Handbook* § 19.03(B) (Richard K. Allen & Stanley A. Martin eds., 2009).
2. *See, e.g. Zurich Am. Ins. Co. v. Pa. Mfrs. Ass'n Ins. Co.*, 2003 WL 23095605 (N.J. Sup. Ct. App. Div. May 7, 2003) (Zurich argues leaking windows were not an onsite exposure since the shop drawings were not prepared on site and the windows had been manufactures and tested off site. The court concluded that the occurrence was when the windows were installed at the site.).
3. *See* The State of Wrap-ups April 2008, by R. Resnick, http://irmi.com/expert/Articles/2008/Resnick04.aspx.
4. *Id.*
5. *Id.*
6. *Id.*

"To Be or Not to Be"—Surety Takeover Agreements

by Jacqueline Greenberg Vogt

A general contractor's performance on a major construction project is woefully deficient and has caused numerous delays. To top it all off, some of the work is defective and has to be repaired or completely re-done. The owner of the troubled project finds itself with no option but to terminate its general contractor. The owner calls upon the contractor's surety to complete the work. The surety agrees, but proposes that the owner and the surety enter into a takeover agreement defining the completion.

Is this a good idea vis-a-vis the owner? Which party is the takeover agreement intended to benefit?

This article will recommend that the owner enter into a takeover agreement with the surety to govern their relationship and provide a road map for the completion of the project.

The plain language of a performance bond requires the surety to take over a project and arrange for the completion of the work in the event of a contractor termination. The bond typically states that the surety's obligation under the bond arises when: 1) the owner notifies the contractor and the surety that the owner is considering declaring the contractor in default, 2) the owner has actually declared the contractor in default and formally terminated the contractor, and 3) the owner has agreed to pay the balance of the contract price to the surety.

Whether the owner should enter into a takeover agreement requires the consideration of a number of factors. On the pro side, in the course of negotiating the takeover agreement, the owner can require the surety to confirm the contractor's default and affirm that the surety is bound by the contract documents. The agreement should include statements: 1) confirming that performance deficiencies existed, and 2) setting forth the specific reasons for the default and termination. Such provisions lay a good foundation for estopping the surety from being able to later claim the contractor was improperly defaulted or terminated.

Also, entering into a takeover agreement will require the owner and surety to examine and agree upon the remaining scope of work. The surety will typically hire a construction consultant to review the work in place, compare it to the specifications and identify the scope. The owner then has the opportunity to agree or disagree with the surety's evaluation of the remaining scope. This is an opportunity to identify and correct defective or non-conforming work in place before project completion.

The process outlined above also results in the owner and surety coming to an agreement on the remaining contract balance. So long as the owner commits to paying over the contract balances to the surety, the owner is assured of getting a completed job for the contractually agreed upon price.

The owner also benefits from a takeover agreement when a date for completion is agreed upon. By the time a contractor is terminated and the surety steps in, a project is likely to be delayed. A negotiated completion date in the takeover agreement requires the surety to commit to a schedule that gives the owner some idea of when to expect completion. Even if additional delay occurs, the owner is still better able to plan its use of the project.

In the takeover agreement negotiation, the owner can profit by obtaining new and additional undertakings, which go beyond the promises made by the surety in the bond itself. Indeed, this process provides the owner the opportunity to include language in which the surety concedes that the obligations under the bond are triggered, and that the surety is, therefore, obliged to complete the work.

Another example of additional benefit relates to liquidated damages (LDs). Liquidated damages are not specifically mentioned in the typical bond. In the course of negotiating a takeover agreement, an owner can demand that the surety agree to be responsible for LDs. Although there are many scenarios under which a surety would never agree to pay LDs, if the contractor's performance was clearly deficient and the surety is concerned about its exposure to LDs, it might agree to be liable for a capped amount of LDs to limit that exposure.

The owner can also gain an advantage in negotiating changes to the dispute resolution procedure. For example, the parties can agree to an expedited process that can start and be completed quickly during the completion work, rather than go through the longer-staged claims process typically utilized in the American Institute of Architects (AIA) forms of contract. The parties can also make changes to other parts of the dispute resolution procedure, such as venue or the number of required arbitrators.

The takeover agreement can be a means by which to identify claims that exist as of the termination. Language in the takeover document can be used to waive any claims that are not specifically identified. Also, the agreement can identify liens and require the surety commit to obtaining lien releases prior to commencing completion work. The owner can also use the takeover agreement as a means for confirming and assigning liability to the surety for latent defects.

Also, if the surety decides to use the terminated contractor as its completion contractor, the owner can demand the surety take on the cost of a surety's representative to supervise the work of the contractor. This clearly benefits the owner.

Finally, by the surety completing the work under a takeover agreement, the surety may also be committing itself to pay for the completion work, even if the cost to do so exceeds the penal sum of the bond. Some courts have enforced the so-called 'default rule' that the penal sum limitation security is lost when the surety steps in to complete project.[1] In the *Deluxe* case, the New Jersey District Court determined that the surety's own undertakings in the takeover agreement exposed it to obligations beyond the penal sum of the bond when it breached the takeover agreement.

There are a few downsides to entering into a takeover agreement. For instance, both the owner and surety usually seek to reserve all claims and defenses in the agreement. This means the impact of the additional obligations and promises made in the takeover agreement may be limited. Also, it takes time to negotiate a takeover agreement. This can cause further delays to the completion of the work. And, just as the owner may negotiate more favorable terms for itself than exist in the original contract, so may the surety. However, when all of the above considerations are factored in, it still makes sense for an owner to negotiate and enter into a takeover agreement with the contractor's surety.

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Endnote

1. *See, Deluxe Building Systems, Inc. v. Constructamax, Inc*., 2013 WL 4781017 (D.N.J. Sept. 5, 2013).