WHEN YOUR PUBLIC CONSTRUCTION PROJECT GOES BAD

By Christopher J. Petrini*

This article will address common dilemmas public owners face when general contractors are unable to complete a project or have delayed a project to the extent that a public owner is considering serving a Notice of Default on the general contractor and making a demand under the General Contractor's bond. In these circumstances, it cannot be stressed enough that counsel for the public owner needs to make contact early in the process with a representative from the project's surety company, and to timely provide all written notices required under the bond. This must be done to effectuate a smooth transition (perhaps an oxymoron) between a non-performing contractor and the surety and replacement contractor. Early intervention and notice also removes a primary defense of surety--alleged prejudice to the surety due to a claimed failure by the owner to provide proper notice so as to allow the surety time to evaluate and select its options under the bond to complete the project and therefore mitigate its damages. While there are a host of issues to be resolved when a surety is called in to satisfy its bond obligations, communication between the owner, the surety, the architect, and the new general contractor or completion company is vital to protecting the owner's interests. This article will examine common issues that arise in communicating with a surety, tips for drafting a takeover agreement, claims against a surety where appropriate, and handling demands for direct payments from subcontractors.

A. Communication with the Surety

This section will deal with those circumstances where the surety cooperates with the owner. When a general contractor is unable to complete a project or has abandoned a project, the owner must contact the surety or its representative (as set forth in the bond) in writing as soon as possible to make them aware of the owner's intentions. If the owner wishes to properly trigger the surety's obligations under the performance bond, the owner must satisfy the technical notice requirements of the applicable performance bond. For instance, using a typical performance bond attached as **Exhibit A** (Form EJCDC No. 1910-28a, 1984 edition), the owner must take each of the following steps in sequential order:

1) Notify the contractor and surety that the owner is considering declaring a contractor default and request a conference with the contractor and the surety to be held within 15 days after receipt of such notice to discuss completion of the contract;

2) Declare contractor default and formally terminate the contractor; and

3) Agree to pay the surety the balance of the contract price in accordance with the underlying construction contract in exchange for the surety's agreement to complete the same.

When an owner declares a contractor default, the owner must do so in writing and serve the contractor default via certified mail, return receipt requested upon the contractor and the surety. It is critical that a "declaration of default sufficient to invoke the surety's obligations…be made in clear, direct, and unequivocal language." Seaboard Surety Company v. Town of Greenfield, 370 F.3d 215 (1st Cir. 2004) (citing L & A Contracting Co. v. S. Concrete Serv., Inc., 17 F.3d 106, 111 (5th Cir.1994) (finding insufficient notice of default when owner's letters never mentioned the word "default"); Elm Haven Constr. Ltd. P'ship v. Neri Constr., LLC, 281 F.Supp.2d 406 (D.Conn.2003) (insufficient notice when letters only complained about performance and financial status); Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc., 986 F.Supp. 82, 86 (D.Conn.1997) (insufficient notice when letters only mention delay in performance)).

The technical requirements discussed above are those that an owner must satisfy for the particular bond attached as Exhibit A. Most performance bonds, however, have similar provisions as those set forth in the attached Bond. Practitioners are advised to examine their applicable performance bond closely and to seek guidance from counsel or the project architect regarding the contents and service requirements of any notices. One common element in performance bonds is that owner must clearly notify the surety in writing that the contractor has defaulted and clearly demand that the surety satisfy its obligations under the bond. Without such notification, a surety may allege that the failure to notify the surety of contractor default has caused prejudice to the surety and effected a discharge of the surety's obligations under the bond.

Once the owner has defaulted the general contractor and the surety has properly been placed on notice, the surety will usually have a choice regarding the manner to satisfy the performance bond. The surety's options are as follows:

1) Arrange for the original contractor to complete the project;

2) Undertake to complete the construction contract itself (acting as the general contractor while hiring subcontractors to actually perform the work);

3) Obtain bids or negotiated proposals from qualified contractors acceptable to the owner for a contract to complete the project;

4) Waive its right to perform the contract and with reasonable promptness:

   a) Determine the amount for which it may be liable to the owner and tender payment to the owner (the buy out option); or

   b) Deny liability in whole or in part and notify the owner stating reasons therefore.

See Exhibit A, Sec. 4.1-4.4.

While the owner can attempt to negotiate or influence a surety's selection of options, the bond language in most performance bonds gives the surety the discretion to choose one of the four options listed above. In many cases, a surety will follow Option No. 2 above and retain a completion contractor to perform or supervise the completion of the work. In that case, it is necessary for the owner and surety to negotiate a takeover agreement.

B. Takeover Agreements

If the surety follows Option No. 2 under Section 4.2, the surety usually will propose a takeover agreement and present it to the owner for approval. Municipal counsel or special counsel must examine the proposed takeover agreement carefully and make edits or additions to the proposed agreement that are protective of the owner's interests. A sample takeover agreement is attached as **Exhibit B**. Here is a listing of several relevant provisions that should be included in such Takeover Agreements:

- A provision stating that the surety and the completion contractor are bound by the original construction contract and are obligated to the municipality to same extent as was the original general contractor.

- A provision dealing with demands for direct payment requests from subcontractors. The owner should withhold the amount of outstanding direct payment demands from the contract balance to be paid to the surety. The Takeover Agreement should include a provision placing the onus on the surety to handle such direct payment demands, and require an indemnification of the municipality for any future demands. The owner should work with the project architect to confirm the amount of subcontractor work that has been performed under the relevant demand, and how much of the funds that have been retained by the owner should be released to the surety.

- For projects close to completion, a monetized punch list should be prepared and incorporated into the Takeover Agreement. The project architect, owner representatives and the takeover contractor will need to meet several times to develop an accurate punch list.

- The general contract provisions for insurance coverage and naming of municipality as additional insured set forth in the General Contract should be expressly carried over into the Takeover Agreement. The Takeover Agreement should also require inclusion of a new certificate(s) of insurance as an exhibit. This certificate(s) of insurance should show that the completion contractor has the same coverage types and in the same amounts as required by the original contract, and should name the owner as additional insured for the same coverages as required under the original contract.

- A provision allowing the municipality to assess liquidated damages in the event of untimely completion of the project.

As referenced above, the owner will need to work closely with the project architect when drafting the Takeover Agreement, and will need to rely upon the architect for verification of various monetary amounts. As stated above, the architect will also need to work with the surety to 1) develop a monetized punch list for incorporation into the agreement; and 2) agree on change order amounts and status of demands for direct payment. I further recommend that municipal counsel retain special counsel experienced in public construction and in negotiating such agreements, as these agreements tend to be complicated and include a substantial number of industry-specific terms and concepts.

C. Claims Against a Surety and General Contractor

Owners need to carefully satisfy the technical requirements referenced above prior to commencement of litigation against a surety. In addition to issuing a written Notice of Default as discussed in Section A above, the bond may obligate owners to send further notices prior to filing a claim. For instance, the performance bond attached as Exhibit A includes an "additional written notice" requirement. Specifically, the municipality must take the action of sending the "Additional Written Notice" required by Paragraph 5 of this bond to properly establish the surety's liability and default under the bond. Recent case law has found that where an owner fails to follow the notice requirements in Paragraph 5, the surety may properly be discharged from its obligations. See Seaboard Surety Company v. Town of Greenfield, 370 F.3d 215 (1st Cir. 2004) (where owner's letters to surety failed to alert surety of possible surety default or failed to warn surety of default on bond pursuant to Paragraph 5 of bond, the owner was found to be in breach of the bond and the surety discharged). A sample "Additional Written Notice" is attached hereto as **Exhibit C**.

Another requirement that must be reviewed and considered is whether the bond contains a shorter statute of limitations periods than ordinarily provided by operation of law. For example, the bond attached as Exhibit A contains a two-year limitation period. Such provisions will be enforced by the court so long as such limitation periods are reasonable. "The law is settled in this circuit, based in Massachusetts law, that contracting parties may agree upon a shorter limitations period as long as it is reasonable." I.V. Services of America, Inc. v. Inn Development & Management, Inc., 7 F.Supp.2d 79 (D.Mass.1998) (citing Hays v. Mobil Oil Corp., 930 F.2d 96, 100 (1st Cir.1991) (approving a one year contractual limitations period for unfair and deceptive business practices).

The bond attached as Exhibit A includes a two year limitations period. After satisfying the notice requirements of the bond, any suit filed against the surety may include the following counts:

1) **Specific performance**: This claim will allege that the bond remains in full force and is a valid and enforceable contract, and will seek a court order requiring the surety to comply with its obligations under the bond.

2) **Breach of Contract:** The complaint against the surety should also include a claim for breach of contract. The breach of contract claim should seek damages over and beyond the penal sum stated in the performance bond, to the extent such damages have been incurred by the municipality. Normally, the amount of damages in a breach of contract case on a performance bond cannot exceed the penal sum. However, where the plaintiff/obligee proves the surety breached its own performance bond obligations, liability may attach for sums greater than the penal sum. See Continental Realty Corp. v. Crevolin, 380 F.Supp. 246 (S.D. W.Va. 1974). In addition, such a breach of contract claim will seek interest on any damage award. Massachusetts courts have held that accrued interest will be added to the penal sum when determining any award to the owner. Union Market Nat'l Bank v. Nonantum Investor Co., 291 Mass. 439 (1935) (awarding interest calculated from time of default when damages were in excess of the penal sum).

3) **A claim for violation of Chapter 93A and Chapter 176D**. A third count that should be considered is one for unfair claims settlement practices in violation of G.L. c. 176D and 93A. A surety's violation of C. 176D by unreasonable denial of a claim, unfair settlement practices, or otherwise failure to act is actionable by suit under G.L. c. 93A. See Granger & Sons, Inc. v. J & S Insulation, 435 Mass. 66 (2001) (citing Kiewit Construction Co. v. Westchester Fire Ins. Co., 878 F.Supp. 298, 301-302 (D.Mass. 1995) (holding that violations of G.L. c. 176D for unreasonable settlement practices constituted "persuasive evidence" that surety willfully or knowingly engaged in unfair business practices proscribed by 93A)).

Public owners should also consider naming the defaulted contractor as a defendant. In most circumstances, such claims against the defaulted defendant will be paper claims only because the defaulted contractor is financially insolvent and unable to satisfy any judgment. Even when this is so, where a defaulted contractor has failed to complete the contract or otherwise breached the original general contract, the owner should still file suit against the general contractor to limit the ability of surety's counsel to "point to the empty chair" and to facilitate discovery of the general contractor's documents and witness testimony. Each case differs on the facts, but the typical claims against a defaulting general contractor will be for breach of contract for failure to reach substantial and final completion, a claim for liquidated damages where appropriate, and perhaps other claims specific to the project at issue.

D. Demands for Direct Payment

Another issue that commonly arises in cases of contractor defaults is the demand for direct payment. This section will briefly examine the municipality's responsibilities where a subcontractor serves a demand for direct payment. As soon as the demand for direct payment is received, the public owner should examine the demand for technical

compliance with the direct demand statute, G.L. G.L. c. 30, §39F. The basic requirements of a demand for direct payment are as follows:

> (1) The subcontractor must be within the defined class of "subcontractor" set forth in G.L. c. 30, §39F(3). If the subcontractor is not entitled to protection via this statute, the subcontractor would then have to show it was approved by the municipality "in writing as a person performing labor or both performing labor and furnishing materials pursuant to a contract with the general contractor" as provided in G.L. c. 30, §39F(3).
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> (2) The demand for direct payment must contain a "sworn statement delivered to or sent by certified mail to the awarding authority" within the required time frame as required by G.L. c. 30, §39F(1)(d). In addition, the demand must contain a detailed breakdown of the balance due under the subcontract and also contain a statement of the status of completion of the subcontract work.
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> (3) The owner must respond within 15 days of receiving the demand (but in no event prior to the seventieth day after substantial completion of the subcontract work). G.L. c. 30, § 39F(e). In accordance with the statute, the awarding authority "shall make direct payment to the subcontractor of the balance due under the subcontract, including any amount due for extra labor and materials furnished to the general contractor, less any amount (i) retained by the awarding authority as the estimated cost of completing the incomplete or unsatisfactory items of work, (ii) specified in any court proceedings barring such payment, or (iii) disputed by the general contractor in the sworn reply; provided, that the awarding authority shall not deduct from a direct payment any amount as provided in part (iii) if the reply is not sworn to, or for which the sworn reply does not contain the detailed breakdown required by subparagraph (d)." G.L. c. 30, § 39F(e).

CONCLUSION

In the case of general contractor default, the public owner must review the terms of any performance bond carefully and act promptly to ensure that its rights under the bond are preserved. Technical written notice requirements must be strictly complied with before commencement of suit against the surety. Demands for direct payment in cases of general contractor default must be carefully and swiftly dealt with by the public owner, both by provision for the same in the Takeover Agreement and by responding to said demands in a timely and proper fashion as required by G.L. c. 30, §39F.

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2007.02.02 MCLE Municipal Law Seminar Presentation (2700-23)