CONTRACTS

Line of Defense

managing the risk of subcontractor default

By Christopher S. Drewry

There are few things more crippling to the progress and budget of a project than a contractual default. Needless to say, the best preventive medicine is to avoid the default altogether. However, if one does occur, it is critical to execute the default and any termination in accordance with the governing contracts. If you receive a default notice, it is equally important to properly respond to protect your company. In theory, this advice is easy, but it can be far more difficult in practice.

AVOIDING THE DEFAULT

Do Your Homework. The first line of defense to avoiding the default scenario is due diligence and setting up an effective pre-qualification plan. Every successful pre-qualification plan solicits key financial information such as financial statements, sales volume/revenue, cash/assets, and assessment of current accounts receivables and liabilities. Securing banking information can be critical in the event of a default down the road and the need to find assets. Obtaining information on the level experience and history, projects and/or history of prior defaults or litigation is similarly vital. Other information to obtain includes licenses/certifications held, the ownership structure, the project management team and experience of each member, the safety program and record and EMR rating, and references to confirm experience and qualifications.

An integral part of pre-qualification is the interview. This substantiates what is shown on paper and allows the opportunity to ask questions and verify qualifications to ensure the relationship will be a successful fit. Perhaps the most important advice is to view pre-qualification as an ongoing process. It should not end after the applications are reviewed and instead should be a continuing obligation. This can prove just as beneficial as a pre-job interview.

Third-party Backstops. Another piece to due diligence is bonding and insurance. Requiring payment and performance bonds can provide a layer of protection against a default. Even if bonds are not ultimately required, the mere request for bonding offers critical insight, as bonding capacity is a valuable tool in evaluating financial stability. Surety underwriters undergo stringent due diligence investigation during which they obtain much of the pre-qualification information discussed above. Do not exclusively rely on the underwriting process in lieu of your own investigation, but the lack of bonding capacity can be a red flag. Also consider dictating the quality level of the surety furnishing bonding and review any history of defaults under prior bonds.

Securing sufficient insurance coverage likewise can offer security in the event of a default. As with bonding, requesting increased insurance limits can weed out financially weak and vulnerable companies. Consider requiring expanded coverages like contractual and completed operations coverage and/or an umbrella policy. Request to be an additional insured and make such policies primary in the event of a default.

Good Contract Language. The next line of defense is a good contract. To avoid default, or to evaluate whether to pursue one, it is critical to consider not just the formal default and termination clauses, but the parties' interrelated rights and obligations which impact the default. Defective work issues, payment problems, or schedule delays serving as the grounds for default may be addressed in different contractual provisions. Key terms like indemnity, warranty, change order and claim/dispute resolution can provide protection. Strong contractual scheduling requirements—including detailed milestone dates, the duty to monitor/update the schedule, and/or to recover missed deadlines—can minimize defaults.

Keep Your Eyes Open. The last line of defenses is to watch for all-important red flags. Pre-construction, a high bid spread or exceedingly low bid should be the first sign. Other early danger signs include a reluctance to share financials, high debt, and/or declining cash flow/liquidity. A newly formed entity with little performance history or an out-of-market company should also give pause. During construction, front loading of pay applications, schedule slippage, manpower issues, reduced job presence, employee turnover, high volumes of change order requests, workmanship issues, and downstream payment issues are signs of a potential default. When red flags go up, be prepared to assess and possibly implement a default.

EXECUTING THE DEFAULT

The decision to proceed with a default should be undertaken with caution. Default and termination are often "nuclear" options and can result in increased costs and/or further schedule delays. When evaluating a potential default, identify the scope of work

needed, the schedule restraints, and resulting impact to the schedule if a replacement subcontractor is hired. Then, have a clear plan to secure said subcontractor.

If a default is necessary, it is paramount to follow the contractual default and termination procedures. There are typically two options: (1) default and termination "for cause" in the event of a default or a breach of the contract, and (2) termination "for convenience."

With respect to the former, identify the grounds for default—i.e., defective work, lack of adequate manpower, delays, failure to pay downstream subcontractors/suppliers, and other material breaches. Next, ensure strict compliance with the contractual notice requirements, namely how the notice must be delivered and the cure period for default. Allowing the opposing party an opportunity to cure its default is an absolute requirement as a judge/arbitrator will consider the reasonableness of such cure period. A middle ground to a formal default is utilizing a right to supplement the work. With this, a party can perform any completion work itself and charge those costs to the defaulting party while avoiding the risk of a formal termination.

Another alternative is the use of termination for convenience whereby a party has a right to terminate without cause. This right strictly arises from the contract, so without such a clause there is no right to terminate for convenience. The clause should define the notice to be issued and the responding party's entitlement to recover certain costs. Although there may not be grounds to withhold/set off costs due to default, sometimes the termination for convenience is a cleaner remedy to exercise.

RESPONDING TO DEFAULT

If a party is on the receiving end of a default notice, the first step is to immediately investigate the facts surrounding the claim with your project personnel. The recipient should also send an immediate written response to the default notice stating whether the party disputes said notice and on what grounds. If fault is acknowledged, then initiate a cure plan and notify the other party of the steps being taken to cure such default. If the defaulting party is at fault itself, or did not properly execute the default/termination, the responding party may have a right to claim wrongful termination. A wrongful termination could potentially result in the recovery of profit on the unperformed work. Also consider whether there are downstream issues of default and/or notice needed to subcontractors/suppliers that may be the cause of the underlying default. Finally, if there is a performance bond claim, it is important to communicate with your surety and advise of the steps being taken in responding to the default and to send written assurances of performance to the surety. Communication with the surety is the key. ■

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