

Financial and Economic Crisis – Law Firms

Successfully Managing A Troubled Construction Project

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There is no escaping it: these are tough times for construction projects. But, tough times present challenges and overcoming them can be rewarding. So, now is a good time for owners, contractors, subcontractors and design professionals to renew their familiarity with the tools available for managing construction projects in times of tight money. The strategy is simple in concept: first, identify the warning signs of a troubled project; second, review the contract and applicable law to develop a plan tailored to the specific situation the project faces; and third, if the plan fails, be ready to enforce your rights. Implementing the strategy requires that the parties involved be steeped in the details of the project scope and the commercial status of the project and be nimble in a quickly changing environment. The purpose of this article is to give the experienced reader a refresher on the contract terms and law typically applicable in financial disputes in construction and to give the uninitiated a primer in that area.

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A. Warning Signs: Recognizing Potential Problem

Of course, the first challenge is distinguishing between financial pressure on a project and the normal stress of the design and construction process. Although the signs differ depending on your role in the project, all of them have a common thread: an effort to hoard the project's cash. The earliest evidence of trouble will often be either in monthly payment requisitions, progress reports or project correspondence. Reconciling the reporting in these documents with physical progress will be the best source from which an owner can see the impact of financial stress on the project. Some signs for the owner to watch out for are as follows:

- Less progress toward completion than planned;
- Overstatement of claimed vs. actual



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progress;

- Reduced labor force;
- Increased number of requests for information and change orders;
- Delayed payments to subcontractors and liens; and
- Creation of a paper trail.

Contractors, subcontractors and design professionals also need to watch for signs that the owner is struggling financially. This can be more challenging, since the owner has fewer reporting requirements and its financial issues do not manifest themselves in physical progress. However, this imbalance is addressed to some extent by lien rights, trust fund laws and other legal authorities that give contractors and subcontractors enhanced standing against other creditors of the owner.¹ Contractors, subcontractors and design professionals should be alert for:

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- Slow review/evaluation of progress payments;
- Increased pushback regarding claimed progress and completion of milestones;
- Rejection of well-founded change order requests; and
- Creation of a paper trail.

B. The Tools Of The Trade

Once the problem is recognized, the project players can start applying the available tools to manage and overcome the challenges – hopefully, without major disruption to the project. The sources for addressing issues created by financial pressure come predominantly from the contract and, to a lesser extent, from statutes.

The contract is the best place to start for addressing financial stress. Generally, owners should look to three kinds of provisions: those that relate to information the contractor is required to provide, those that relate to payment and those that relate to security for the contractor's performance. Contracts vary widely in the kind of information that the contractor is required to provide the owner depending upon the size of the project, the type of contract (lump sum, cost reimbursable, etc.) and market conditions. At one end of the spectrum are contracts that require the contractor to provide detailed cost and progress information to the owner and are subject to the owner's audit rights; at the other end are contracts that only call for the provision of some progress data in the contractor's monthly payment requisitions. Regardless of what the contract provides, the goal is to use these provisions to get the most information possible and to start asking questions.

Once the owner has determined whether the contractor is complying with the substantive performance requirements of the contract, it can choose from a panoply of provisions to protect its interests. Using the AIA Form 201 contract as a template, these provisions include: §2.3 (owner's right to stop the work); §2.4 (owner's right to carry out the work); §5.4 (contingent assignment of subcontracts); Article 9 (payments and completion); §9.6 (progress payments contractor shall promptly pay subcontractor); Article 11 §11.4 (performance bond); Article 12 (uncovering and correcting work); Article 14 (termination or suspension of contract), §14.2. (by owner for cause); §14.3 (suspension by the owner for convenience); §14.4 (termination by owner for convenience).

Owners also have a variety of opportunities to involve third parties where the

contractor's financial condition calls into question the contractor's ability to finish the project. These include surety bonds, collateral letters of credit, parent company or affiliate guaranties and assignment provisions that enable the owner to take over and complete the project.

Finally, owners also have to be concerned with payments to subcontractors because of the potential for liens. Here, they can look to the protection of trust fund laws in jurisdictions like New York where they are in force and to contract provisions that allow owners to deal directly with subcontractors by issuing joint checks to them and the contractor to assure payment for work performed by a subcontractor or vendor. The New York version of the trust fund law provides that contractors hold in trust for subcontractors and materialmen all funds received from the owner in connection with the work project. *N.Y. Lien Law Art. 3A § 70-79-a* (McKinney 1993)(“Lien Law”).² “The statutory trust created under New York law arises by operation of law as soon as the contractor receives any funds from the owner.” *In re Silba*, 170 B.R. 195 (Bankr. S.D.N.Y. 1994). Subcontractors and materialmen become beneficiaries of this trust upon executing a contract with the contractor. Art. 3A § 71(5); *In re Westchester Structures, Inc.*, 181 B.R. 730 (Bankr. S.D.N.Y. 1995). Courts have found that the purpose of the trust fund law is to ensure that the statutory trust fund amounts reach the intended beneficiaries, thus protecting those whose skill, labor and materials made possible the performance of a construction contract. *In re Coyne Elec. Contractors, Inc.*, 244 B.R. 245 (Bankr. S.D.N.Y. 2000) quoting *Aquilino v. United States*, 10 N.Y.2d 271, 278, 219 N.Y.S.2d 254, 176 N.E.2d 826 (1961).³ These statutes, therefore, take control of project monies from the financially strapped contractor and, in effect, give it to the owner and subcontractors. Used properly, this can facilitate continuation of construction. The same is true for contract provisions allowing the owner to facilitate prompt payment of amounts due to subcontractors by permitting direct contact with them for the limited purpose of arranging payment and the issuance of joint checks to the contractor and subcontractor.⁴

Contractors also have contractual tools available. However, their ability to access information needed to recognize the owner's financial problems is relatively weak – generally, not good enough to avoid doing work before recognizing a threat to

payment. This is why statutes confer lien rights on contractors, subcontractors and vendors. In addition to lien rights, under most contracts, the contractor can utilize a right to stop work provision and/or the right to terminate the contract if it is not paid. In addition, where equipment is involved, the contractor can generally require the execution and delivery of UCC financing statements, which places a lien on the equipment until it is paid in full. It can also pursue claims against the owner for non-payment or for change orders for additional time and/or additional cost for performance. Again using the AIA Form 201 as a template, these provisions are: Article 9 (payments and completion); §9.7, Failure of Payment (if the owner does not make payment within a specified time, the contractor can stop work until payment is made); and Article 14 (termination or suspension by the contractor).

C. Points To Consider

Owners and contractors alike should remain alert on projects, looking for signs of trouble on either side. Once those warning signs appear, the party in jeopardy should begin to prepare a strategy without delay. Although there is no perfect project scenario, a contractor or owner can utilize contract provisions and statutory protection in order to safeguard their investment in the project and to facilitate project completion.

¹ Design professionals are not beneficiaries of these legal provisions.

² The applicable statutory provision states that “[t]he funds described . . . shall constitute assets of a trust . . .” *N.Y. Lien Law Art. 3A § 70(1)*. The statute further provides that “[t]he funds received by a contractor or subcontractor and the rights of action with respect thereto, under or in connection with each contract or subcontract, shall be a separate trust and the contractor or subcontractor shall be the trustee thereof.” *Id.* at § 70(2).

³ Other states have similar, though not identical laws. These include: Arizona: *Ariz. Rev. Stat. 33-1005* (residential projects); Colorado: *Colo. Rev. Stat. Ann. §38-22-127*; Delaware: *Del Code Ann. tit. 6, § 3502*; Illinois: *770 ILCS 60/21.02*; Maryland: *Md. Code Ann., Real Prop. §§ 9-201*; Michigan: *Mich. Comp. Laws Ann. § 570.151*; Minnesota: *Minn. Stat. Ann. § 514.02* (2003); New Jersey: *N.J. Stat. Ann. §§ 2A:29A, et seq.* (applies to private parties who have forwarded money toward the purchase of a “dwelling house,”) and *N.J. Stat. Ann. § 2A:44-148* (public works projects); Oklahoma: *Okla. Stat. Title, 42, §§ 152 and 153*; South Carolina: *South Carolina Code §29-7-10*; South Dakota: *S.D. Codified Laws § 44-9-13* (2004); Texas: *Tex. Prop. Code Chapter 162*; Vermont: *Vt. Stat. Ann. Title. 9, § 4003*; Washington: *Wash. Rev. Code § 60.28.010* (public works projects); Wisconsin: *Wis. Stat. § 779.02(5)* (2003) (private projects) *Wis. Stat. § 779.16* (2003) (public projects).

⁴ See, e.g. *AIA Document 201 – 2007, General Conditions, Article 9, §9.5.3* (joint checks); §9.6.4 (owner's right to request written evidence of payment and right to contact subcontractors if evidence not provided in seven days).