



I DON'T WANT TO PAY TWICE

TIPS FOR GENERAL CONTRACTORS: HOW TO AVOID PAYING TWICE FOR YOUR SUBCONTRACTOR'S WORK

No one likes to pay twice. It is financially painful and frustrating. While there is no silver bullet, there are steps general contractors (“GCs”) can take to make it less likely that they will have to pay twice. It all starts with good planning: bonding the subcontractor, ensuring it has the right insurance coverages, and using a subcontract that protects the GC and addresses future problems.

The Pre-Work

The GC should consider bonding its subcontractors, or at least those taking on large portions of work; work that will be on the critical path; work that is complicated, difficult, time sensitive, specialized and/or hard to replace; work with long lead times; and proprietary work. If the subcontractor fails to pay its vendors or files for bankruptcy protection, the subcontract performance and payment bonds will not be viewed as property of the bankruptcy estate. Therefore, performance and payment bond claims can still be made and the subcontractor’s surety will have to address these claims.

When selecting the subcontract bond, the GC should confirm that the bond’s coverage is at least as broad as the GC’s bond to the owner. A GC should have its own subcontract bond forms. This ensures consistency for the GC across projects and that the GC’s interests are protected. The GC should pay attention to the issuing surety’s A.M. Best rating and its claim handling reputation.

The subcontractor should carry workers’ compensation insurance, commercial general liability insurance (“CGL”) listing the GC as an additional insured, and any other appropriate business insurance that the owner requires, at limits, which, at a minimum, are equal to the contractual requirements of the prime contract. The GC should verify that these coverages are in place. A declaration sheet is insufficient. The GC should procure a copy of each policy in full. Proper insurance is important given the frequency with which construction defect claims arise after the project is complete, sometimes many years later.

Finally, at the time of entering into the subcontract, the GC should require that the subcontractor provide a list of all lower-tier vendors. Ideally, this will be an exhibit to the subcontract. The GC needs to know whether the subcontractor is fully self-performing the work or has bought out the full scope that has been subcontracted to it. The GC should know the identity of every company that is supplying labor and/or materials on the job.

The Subcontract

It is not practical to include subcontract provisions to cover every possible situation that might arise. A long-form subcontract can be too unwieldy and is unappetizing to potential subcontractors. It is important to know which provisions are key for consideration and why. This section discusses the top provisions that are important for the GC to consider including in its subcontract.

Prior to issuing each payment, the subcontractor should submit its own lien waiver and lien waivers from all of its lower-tier vendors. Using the list of lower-tier vendors provided by the subcontractor at the time of contracting, the GC can verify that it has received waivers from all lower-tier vendors covered by the pay application. At the next pay application, the subcontractor should provide proof of payment to each lower-tier vendor. A verification provision in the subcontract permits the GC to follow up with each lower-tier vendor to confirm payment has been received. This gives the GC an opportunity to address nonpayment situations early on and take steps to prevent payment bond claims and being stuck paying twice.

The GC should consider using a direct payment provision rather than a joint payment provision. Many GCs have joint check provisions in their subcontracts and are surprised when they learn they have to pay twice because the subcontractor enticed the lower-tier vendor to endorse the check and then did not pay, or that the subcontractor forged the lower-tier vendor's signature, or that a bank permitted the subcontractor to cash the check without both signatures present. When a GC issues a joint check, the intention is to prevent the lower-tier vendor from pursuing it (and its surety) for payment. Use of joint checks is helpful, but only if properly used and enforceable in the state in question.

Only **fifteen states** enforce joint checks, and issuance of a joint check is not a defense available to the contractor or the surety on federal projects.

If the subcontractor seeks bankruptcy relief, the joint check may not protect the contractor from having to pay twice. Given the issues with joint checks, and the relatively small number of U.S. states that enforce their use, the better option may be a direct payment clause in the subcontract. This permits the GC to directly pay lower-tier vendors agreed sums and deduct those payments out of the subcontract balance.

Along the same lines as direct payment to lower-tier vendors, the GC may want to consider either directly purchasing materials and supplies its subcontractors will use or requiring the materials be delivered to the job site. This allows the GC to control the location of materials and (if the GC purchases the materials) it permits the GC to avoid unforeseen claims from unpaid suppliers. The GC's purchase of the materials and supplies gives the GC title to the materials, and protects the materials from the subcontractor's creditors. Alternatively, the GC may consider a provision stating that title to the materials is transferred to the GC when it pays for the materials. When the GC holds title to the materials, it is a priority, secured creditor. Priority secured creditors have superior title to lending banks.

A termination for convenience clause permits the GC to terminate the subcontract, at the GC's convenience, for an agreed upon price. The clause states a specific calculation of damages the GC must pay to the subcontractor to part ways. This is helpful if the GC wants to either not deal with the termination process, is not happy with the working relationship, or any other reason.

There are times when a GC does not have the basis for termination, does not want to terminate or simply does not have the time to terminate the subcontractor. This usually happens when the subcontractor's work falls behind while on the critical path or near completion. It can also happen when a subcontractor files for bankruptcy protection and it is entitled by law to what is called an automatic stay. In these situations, use of other provisions to move the project along can be helpful. One such provision that can help is a right to supplement forces provision.

This provision allows the GC to provide labor and materials to "supplement" the work of a defaulting subcontractor and offset the cost of doing so from the subcontract balance, thereby keeping the project moving forward toward completion.

Before exercising its rights under this provision, the GC should analyze the scope of the remaining subcontract work and the cost to perform the work. It may be more economically feasible for the GC to pursue a performance bond claim or, absent a surety bond, terminate and complete the job with another subcontractor.

Another provision that is helpful to GCs is the set off provision. If the subcontractor has performed well and is owed money by the GC on other jobs, but fails to perform well on this job, or fails to pay lower-tier vendors on this job, the GC can use the money owed on the other jobs to satisfy the obligations owed on this job. Absent this provision, the GC would have to file a lawsuit and pursue the matter in court.

Using the Subcontract and Bonds

Not every breach of contract justifies a termination for default and a bond claim. In order for the GC to call on the surety to take action under the performance bond, the breach must be material. A material breach is one defined as of such a magnitude that the obligee is justified in terminating the contract. The GC must look to the subcontract provision that defines the basis for default and enables the GC to terminate the contract. This is also the very reason why the GC must adhere to its own subcontract to ensure it has not waived the breach. The GC must manage its subcontract throughout the project to avoid issues and nip developing issues in the bud.

The GC should commit itself to enforcing its subcontract. Good subcontract provisions that protect the GC are not useful if they are not used or if they are misused. Arguments can be made that subcontract provisions have been waived by patterns and practices of the parties' behavior. Below are examples of proper contract use.

The GC should require the subcontractor to maintain the project schedule. If the subcontractor does not maintain the project schedule, this should be documented in a letter to the subcontractor with a copy to the surety. The importance of documentation cannot be overemphasized. If the GC wishes to pass liquidated damages on to the subcontractor, if the GC opts to supplement the subcontractor's forces to maintain the schedule, or if the GC ultimately terminates the subcontractor, the proper documentation of these issues may mean the difference between a winning and a losing argument. The subcontractor will be entitled to notice, and absent written notice, the GC may have a hard argument to overcome.

Payments should be made in accordance with the subcontract and what has been earned, no more, no less. Often, GCs fall into the trap of paying subcontractors, even though the work has not advanced to where it should be, as an incentive to move the work along. Unfortunately, the work frequently does not move along and the GC is left with a subcontract balance that is insufficient to complete the work. The surety will then raise this as a defense to the performance bond claim saying the GC has overpaid the subcontractor. If this occurs, the surety may be released to the extent of the overpayment if the surety has been prejudiced by this action. The GC has now left the surety with a project to complete and insufficient funds with which to do so. It is better to pay only what is due and protect the subcontract balance so it may be used to complete the remaining work.

The GC should **promptly notify** the subcontractor's surety if the subcontractor does not maintain the project schedule; is not making payments to lower-tier parties; is not performing properly on the project; or otherwise seems in distress.

The GC will never have an issue with putting the surety on notice too soon, but can create an issue by waiting too long. There are a bevy of cases addressing the woes that befall bond obligees

that fail to promptly notify the surety of performance default issues, depriving the surety of its right to mitigate damages and act under the bond. In certain circumstances, the surety has been released from its bond obligations due to the prejudice created by the obligee's failure to timely notify the surety and provide it an opportunity to mitigate damages and cure the default.

The GC must read the bond provided and adhere to all the conditions required to trigger the surety's obligations; otherwise the GC could lose the protection provided by the bond. There are very specific requirements in performance bonds, and they vary by bond. The GC may not be able to self-perform the subcontractor's work, terminate the subcontractor, or hire another subcontractor to complete the work, if doing so is contrary to what is allowed under the performance bond. The GC can certainly make business decisions that are appropriate for it, however, it must recognize that, unless the bond permits those decisions, the result of those decisions may mean that the GC has forfeited its ability to make a performance bond claim.

The GC should understand that the subcontractor's surety will need time to investigate the claim and respond to the performance bond demand. The GC should be a willing participant in the surety's investigation. The GC should provide all documents and information that the surety requests for its investigation. Failing to cooperate will impede and delay the surety's ability to make a prompt decision.

At the same time, the GC should let the surety know if there are emergency issues and/or critical path issues that simply cannot wait and must be addressed. If the defaulted subcontractor's work is on the critical path, it is important that the GC let the surety know and try to obtain the surety's consent to continue the work while the surety completes its investigation. Doing this will eliminate the argument that the GC released the surety by proceeding with the subcontractor's work without the surety's prior knowledge or consent. Also, it should mitigate everyone's financial exposure on the project and help build a better working relationship among the parties.

Travelers developed a new **subcontractor performance bond form** in an effort to respond to the needs of its GCs with respect to the surety's response time and performance under the bond. The goal of this product is to offer GCs a more definitive and expedient response timeline than subcontractor performance bonds have traditionally offered.

Leading up to a bond claim and during the time the surety is investigating the claim, the GC should mitigate its damages. For example, if the problem subcontractor is the roofer and the building is not entirely under roof, the GC should promptly notify the surety under the performance bond terms, obtain the surety's approval prior to performing the work, and then procure installation of the roof protection. The emergency protection should be sufficient to protect the roof work and interior finishes in place, and be appropriately priced. Taking emergency action without meticulously following the bond and contract requirements and trying to obtain the surety's prior consent to the work can result in discharge of the surety.

Putting It All Together

There are no guarantees and no definitive "right" way to ensure a job goes smoothly. There are, however, ways to make it less likely that there will be issues – and good ways to address those issues so that the GC does not have to pay twice. For a more in-depth discussion of these issues, more tips, and more subcontract clauses to consider, see "I Don't Want to Pay Twice" on travelers.com/risk-control.



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