

WHAT TO DO WHEN CONSTRUCTION PROJECTS GO BAD

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It has been a number of years since we have had to worry about construction projects going bad. Unfortunately, the current economic crisis and a declining real estate market has resulted in the first wave of construction project collapses. It is, therefore, appropriate to revisit what to do when construction projects go bad.

In order to be in a position to react properly to a construction project that is in the process of going bad, we first have to be in a position to recognize that it is happening. There are tell-tale signs that a construction project is on the verge of collapse.

From an owner's perspective, warning signs that the contractor is experiencing difficulties that might give rise to a default include:

- Personnel changes with the more experienced superintendent or supervisor being replaced by a far more junior person.
- A slow down in the progress of the work with less manpower showing up on the site to work and subcontractors not showing up to do the available work at all.
- Materials not being delivered when required (i.e. the concrete isn't supplied on the scheduled concrete pour date).
- Subcontractors overheard complaining about not being paid and calls from subcontractors and suppliers are received asking about payment of their outstanding accounts.
- Subcontractor and material suppliers' liens are registered.

From a contractor's perspective, warning the signs that the owner is having difficulty in meeting its financial commitments are less obvious. The following indications of financial difficulty should be watched very carefully:

- Progress claims are not paid when due or are not fully paid.
- Arguments about the payment for extras that had previously been requested, agreed to and priced arise.
- Requests are made to scale back the scope of the project or to find ways for additional costs savings.
- You learn that other contractors working on the site have registered liens.

Once an owner or a contractor comes to the realization that the construction project they are involved in is potentially on the brink of collapse, there are certain initial investigations that should be considered.

From an owner's perspective, the first step that should be taken in these circumstances is to search the title to see if liens have been registered. If no liens are then registered, the owner should nonetheless continue to search the title on the day that any progress payment is made to ensure that the title is clear of liens on the day the payment is made. The owner should as well consider having its consultant review the project to advise as to whether or not in the consultant's opinion: the contractor is maintaining the construction schedule, the quality of the work and materials being supplied comply with the specifications and the contractor's progress claims reflect the value of the work in place.

A contractor should consider searching title to determine if other contractors have, in fact, registered liens and details concerning the amounts claimed. The greater the amount claimed in the contractor's Statement of Lien, the greater the concern. The contractor should as well consider making a request to the owner for reasonable evidence that financial arrangements are in place to allow the owner to pay the amount payable to the contractor. The terms of most construction contracts provide that a contractor is entitled to make this request and receive a response to it. (For instance, see GC 5.1.1 of the CCDC 2 Stipulated Price Contract General Terms and Conditions).

When an owner determines as a result of its investigations and the advice received from its consultant that a contractor has fallen behind schedule and appears to be in financial difficulty, the owner's options are usually set out in the construction contract. Typically, a construction contract will provide that an owner is entitled to give the contractor notice that it is in default and that it is required to either correct the default within the period of time stipulated in the contract or provide a plan that will result in the contractor getting back on schedule (GC 7.1 of the CCDC 2 Stipulated Price Contract is one example of this type of default notice provision). An owner must, however, be careful that any notice of default is sent strictly in compliance with the requirements of the applicable contract provisions. If a letter from the consultant confirming that the contractor is in default is required as a pre-requisite to the owner sending out a default notice, the consultant's letter must be obtained before the owner sends out the default notice.

If a contractor has provided Labour and a Material Payment Bond and a Performance Bond to the owner guaranteeing its work on the project, the owner should as well provide a copy of the default notice to the surety company which issued the Bond. The surety company will normally then commence its investigation of the situation. This will become important should the surety have to step in to arrange for or complete the contract.

If a contractor's investigations disclose that the owner is indeed in financial difficulty, the contractor as well can issue a default notice to the owner setting out the contractor's concerns, giving the owner a specified period of time to reply. A default notice can be sent if the owner fails to respond to a request that it provide financial assurances to the contractor. The circumstances that allow a contractor to send out a default notice and the procedure for doing so is usually spelled out in the contract (GC 7.2.3 of the CCDC 2 Stipulated Price Contract is one example of this type of contractual provision). A contractor should also consider sending a copy of the default notice to its surety to put the surety on notice that there is a contractual dispute with the owner that arises from the owner's default. The surety may have already received conflicting information from the owner and in any case should be kept informed about what is

happening on the project. The contractor, in addition to sending the owner the default notice, should as well register a lien against the project for the amount owing to it.

In the event that the owner doesn't receive a satisfactory response from the contractor to the owner's default notice, the owner will then have to consider its options, which are to hire another contractor and make arrangements for other suppliers to work with the contractor to complete the project or terminate the contract and have others complete it. Which option is chosen will depend upon several factors including the stage of completion of the project and whether or not there are other contractors available in the marketplace which can step in and complete the contract. The owner's choice of options will also be influenced by the position taken by the surety.

Once the owner has determined its course of action, it must give notice to the contractor particularly if the owner has determined that it is terminating the contract. This is because most construction contracts require that a notice of termination following a notice of default be issued. In the event that notice of termination is issued, the owner should then engage its consultants in a review of the status of the work on the date the contract was terminated. The consultant should take careful note of the progress of each phase of the work, deficiencies that have yet to be corrected and what material and equipment have been left on the site by the contractor. This information is important in establishing the progress of the work at the date the contract was terminated, the value of the work in place and will help prove the cost of completing the work. All this information will be necessary in the future to deal with the final contract accounting that will be necessary to set lien funds and deal with the subcontractors, suppliers and even the contractor's liens which will most likely be registered against the project. The surety should be copied with the notice of termination and will as well be interested in receiving the consultant's report on the status of the project.

While it is obvious that an owner will cease paying the contractor for any of the work that had been done on the termination of the contract, the owner still has an obligation to keep records of the cost of completing the contract work and at the end of the day will be required to provide the contractor with an accounting of those costs. In a typical situation, the cost of completing the work is usually greater than the amount owing to the contractor but if it is not, the contractor will be entitled to payment of the difference. This accounting of course will have to take into account any amounts paid by the owner to discharge subcontractors' and suppliers' liens. If a surety is involved, much of this accounting work will be done by the surety and it will settle up the accounts with the contractor at the end of the day.

If the contractor does not receive an appropriate response to its default notice, it can either suspend the work or terminate the contract. Which option is chosen again will depend upon the circumstances of each case. For instance, if the owner's financial difficulties that have delayed payments being made are thought to be temporary, a contractor might choose to suspend the work as opposed to terminating the contract. On the other hand, if there is no assurance that the owner's financial difficulties will be corrected at all or if the owner's ability to pay persist for an unusual length of time, the contractor might consider terminating the contract. In either case, the contractor should take steps to record the status of the work done by it on the project, including any known deficiencies that it has not yet had an opportunity to correct and an inventory of its

equipment left on the site, including any equipment rented from third parties. Should the contractor determine that it is appropriate to terminate the contract, it must remember to cancel any equipment rental contracts it entered into as well as making arrangements to remove its equipment from the site.

The contractor will then be in the position to bring proceedings to enforce its builders' lien and within those proceedings claim any additional damages, including loss of profit and additional overhead expenses that arise from the owner's default and the subsequent termination of the contract.

Dealing with a construction project that has gone bad can be a difficult task especially because everything happens so quickly in these circumstances. However, it can be managed to the best advantage of an owner or a contractor by careful planning and by considering the terms of the contract which not only provides guidance but sets out the rules that apply in the circumstances. By following those rules and keeping appropriate records that will be required later on, the trauma of a construction project that has gone bad can be minimized.