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Contractor Licensing, Lender Security, Bid Protests, and Placement of Bonds and Insurance: Perils to the Start of a Project[*]

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What lies behind the spate of licensing enforcement actions across the United States, and what can construction counsel do to address the problem? This article focuses on the serious consequences of starting work without a proper license and also addresses the similarly drastic impact on construction projects if the parties run afoul of lenders, sureties or rival bidders. Because several types of problems can stop construction projects in their early stages, we start by describing the hazards and why they pose a threat to the project schedule and to viability of the work. We also provide practical advice on how to get troubled projects back on course and some steps *not* to take. The legal issues raised by each danger represent distinct or even unique problems, and therefore we have analyzed each topic separately. Not surprisingly, in every case, the suggested best practice for avoiding the threat should provide the safest course for lawyer and client.[1]

Most of the issues discussed below are governed by statutes or case law of the various states, which obviously vary among jurisdictions. The authors have not surveyed the national jurisprudence on these issues but have concentrated largely on principles of law derived from experience in their respective home states. Though they believe that the state laws referred to below

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[*] Portions of this paper were presented to the annual meeting of the Forum on Construction Law in April 2014 and in a paper entitled Righting the Ship: Getting the Troubled Project Back on Course, authored by Cheri Turnage Gatlin, H. Bruce Shreves, and Charles M. Sink.

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[1] For avoiding many of the perils described here, we recommend Carina Y. Ohara, John I. Spangler III & Michael P. Tarullo, Forms and Substance: Specialized Agreements for the Construction Project (ABA 2007) [hereafter "Forms and Substance"], especially chapters 1 (Pre-bid Agreements), 2 (Financing-Related Agreements), 4 (Preconstruction Agreements), 7 (Mechanics' Liens and Releases), and 8 (Drafting Equipment Procurement Agreements).

are fairly typical, the reader must of course check the statutes and decisions of each state where issues of licensing, bonding or insurance arise to make sure that all applicable requirements are properly addressed.

I. Licensing Issues

A. Introduction

An important but sometimes overlooked source of issues that commonly arises on construction projects is contractor licensing. Most states have established licensing laws for contractors, architects, and/or engineers.[2] While rules vary from state to state, generally a contractor must hold a valid contractor's license in the state in which it is performing construction work. Performing work without a valid license, and in some instances even agreeing to do so, can result in both civil and criminal penalties and greatly diminish a contractor's ability to recover payment for work performed.

In Louisiana, the State Licensing Board for Contractors is particularly aggressive. Virtually every major construction project, public or private, is visited by an inspector from the State Licensing Board, who is likely to require that the general contractor and owner provide a list of all subcontractors on that project. Inspectors then check to ensure that the subcontractors are not only licensed in Louisiana, but licensed in the category in which they are working.

Problems with licensing became particularly acute after Hurricane Katrina. Literally thousands of contractors poured into the state after August 2005 to work on reconstruction of the New Orleans area. A number of these contractors, although licensed in their own states, were not licensed in Louisiana. There was a misconception among numerous contractors that the licensing laws had been suspended due to the emergency. The licensing requirements were accelerated and alleviated in some respects, but they were never suspended. In any event, once an unlicensed contractor was determined to be working on a project, the licensing board would issue a cease and desist order essentially shutting down the project. There was no way to remedy that situation. A subsequently obtained license would not be valid.

B. When a License Is Required

While regulations vary from state-to-state, whether a license is required will generally depend on two factors: (1) the type of work being performed; and (2) the value of the work being performed. Many states provide a broad definition for what con-

[2]*See* Justin Sweet, Legal Aspects of Architecture, Engineering and the Construction Process, at 424 (3d ed. 1985).

stitutes a "contractor," the entity required to have a general contractor's license. For example, in Louisiana, a contractor is defined as

> any person who undertakes to, attempts to, or submits a price or bid or offers to construct, supervise, superintend, oversee, direct, or in any manner assume charge of the construction, alteration, repair, improvement, movement, demolition, putting up, tearing down, or furnishing labor, or furnishing labor together with material or equipment, or installing the same for any building, highway, road, railroad, sewer, grading, excavation, pipeline, public utility structure, project development, housing, or housing development, improvement, or any other construction undertaking for which the entire cost of same is fifty thousand dollars or more when such property is to be used for commercial purposes . . .[3]

This very broad definition can encompass general contractors, architects, and, in certain circumstances, engineers,[4] where the $50,000 threshold for construction work is met.

Licenses generally are issued under different classifications such as building construction, heavy construction, municipal and public works construction, electrical, mechanical, hazardous materials, and plumbing.[5] Further, many states provide for more sub-classifications for even more specialized areas of work. Failure to hold a license within a required classification or sub-classification is a violation of the contractor's licensing law and can result in the rejection of one's bid (should the relevant bid documents require the classification or sub-classification).

One may attempt to subvert the licensing requirements by merely hiring a license holder or joining with another construction company that is properly licensed. However, if a joint venture is entered into, both entities that comprise the joint venture usually need to be licensed.[6]

C. Consequences of Performing Construction as an Unlicensed Contractor

Penalties for performing work without a license are generally enforced by a local state licensing board. The licensing board's power to assess penalties will be governed by the relevant state's

[3] La. Rev. Stat. Ann. § 37:2150.1(4)(a).

[4] La. Rev. Stat. Ann. § 37:2150.1(4)(b).

[5] La. Rev. Stat. Ann. § 37:2156.2.

[6] See J. Caldarera & Co., Inc. v. Hospital Service Dist. 2 of Parish of Jefferson, 707 So. 2d 1023, 1026 (La. Ct. App. 5th Cir. 1998), writ denied, 717 So. 2d 1177 (La. 1998) ("we believe that the trial court correctly interpreted the applicable law to provide that a joint venture is properly licensed when each of its members holds a valid license and, therefore, that joint venture itself is not required to get an additional license to be a responsible bidder under the Public Works Act") (emphasis removed).

laws, but such penalties generally consist of the issuance of stop work orders, fines, and, in some cases, even criminal sanctions.

In addition, performing work without a valid license can make it extremely difficult for a contractor to recover payment for the work it actually performed. For example, in Louisiana, the contract of an unlicensed contractor is an absolute nullity.[7] As noted by one court, because contractor's licensing laws are "enacted to protect an interest vital to the public order, whatever contracting agreement entered into . . . having been done in contravention of a prohibitory law, is void."[8]

Having a construction contract declared null at the beginning of a project can have dire consequences for a contractor. First, and most obviously, the contractor is likely to lose any protections it had under the contract. The contractor would therefore no longer be able to avail itself of forum selection clauses or dispute resolution agreements, losing any procedural control it would have had over a contract dispute. Further, the contractor could lose certain substantive protections contained in the contract, such as a waiver of consequential damages. Worse still, the contractor could lose its right to file a lien on the project, along with any other statutory protections that could have been available. In some states, courts have held that an unlicensed contractor loses the right to file suit altogether. In *United Stage Equipment, Inc. v. Charles Carter & Co.*,[9] the court considering the rights of an unlicensed contractor concluded,

> Generally, where the law contains a penalty for a failure to obtain a license it implies a prohibition to collect on the contract entered into or work done. A departure from this general rule is recognized, however, where the requirement of license is intended only as a revenue producing measure rather than as protection for the general public. Considering that the license fee is simply to help defray the cost of issuing the licenses and the administration thereof, LSA-R.S. 37:2156, we do not here find that the statute in question was ever intended as a revenue producing measure. Hence, the plaintiff did not have a license prior to its being awarded the

[7]Tradewinds Environmental Restoration, Inc. v. Biomedical Applications of LA, Inc., 2007 WL 861156 (E.D. La. 2007); Executone of Cent. Louisiana, Inc. v. Hospital Service Dist. No. 1 of Tangipahoa Parish, 798 So. 2d 987, 993 (La. Ct. App. 1st Cir. 2001), writ denied, 798 So. 2d 116 (La. 2001); Alonzo v. Chifici, 526 So. 2d 237, 243 (La. Ct. App. 5th Cir. 1988), writ denied, 527 So. 2d 307 (La. 1988); Hagberg v. John Bailey Contractor, 435 So. 2d 580, 584–585, 44 A.L.R.4th 253 (La. Ct. App. 3d Cir. 1983), writ denied, 444 So. 2d 1245 (La. 1984) and writ denied, 444 So. 2d 1245 (La. 1984).

[8]*Hagberg*, 435 So.2d at 584–85 (citations omitted).

[9]United Stage Equipment, Inc. v. Charles Carter & Co., Inc., 342 So. 2d 1153 (La. Ct. App. 1st Cir. 1977).

> contract in question, and thus it cannot maintain a civil action on the contract for money due.[10]

However, the loss of the contract does not always mean that the contractor will completely lose its right to recover any payment. Generally, contractors who perform work without a license will be entitled to recover payment under the theory of unjust enrichment. For example, in *Hagberg v. John Baily Contractor*, which concerned a claim of an unlicensed subcontractor against the contractor, the court noted:

> The purpose of the licensing requirements is the protection of the general public "against the incompetent, inexperienced, unlawful and fraudulent acts of contractors." LSA-R.S. 37:2150. This particular case does not present a situation of the type within the intended scope of protection of the licensing statutes. Where incompetency or inexperience or fraudulence is not involved, the licensing statute cannot be invoked to avoid payment of valid charges.[11]

Thus, the court allowed the unlicensed subcontractor to recover under a theory of unjust enrichment. However, the court reasoned that some of the blame belonged on the general contractor, which it found had a responsibility to confirm that the subcontractor was licensed.

Conversely, in *Dennis Talbot Construction Co., Inc. v. Privat General Contractors, Inc.*,[12] the court held that an unlicensed subcontractor was not entitled to recover from a general contractor under the theory of unjust enrichment, despite the general contractor's knowledge that the subcontractor did not possess the required license when work began, because the subcontractor was aware of the law requiring a contractor's license to perform jobs in excess of $50,000.

D. Out-of-State Contractors

1. General Requirements

Generally, a contractor must be licensed in the state where it wishes to perform work. An exception is made if the state has a reciprocity agreement in place, but even then there is generally a formal process whereby the contractor must validate its out-of-state license and confirm the reciprocity. Many states have also established waiting requirements that restrict a contractor from obtaining a license until it has waited a certain number of days after the application for the license is submitted.

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[10] 342 So.2d at 1155.

[11] *Hagberg*, 435 So.2d at 586.

[12] Dennis Talbot Const. Co., Inc. v. Privat General Contractors, Inc., 60 So. 3d 102 (La. Ct. App. 3d Cir. 2011).

2. Performing Work After a Disaster

A major issue arises when a disaster occurs and numerous contractors from other states rush into the devastated area. In this kind of situation, many contractors tend to run afoul of the state licensing laws at the place of the disaster, and they subject themselves to liability as a result. Unless there is a formal directive suspending or loosening a state's licensing laws, the contractor licensing requirements will remain in place even in an emergency.

As noted above, this issue was prevalent in Louisiana after Hurricane Katrina. In Louisiana, the Louisiana State Licensing Board for Contractors is the state administrative body that enforces the license requirements for contractors.[13] Following previous hurricanes, the Louisiana governors had issued executive orders that temporarily suspended licensing laws pertaining to debris removal.[14] However, in the aftermath of Hurricane Katrina, the Governor issued no such order.[15] Nevertheless, the Louisiana Licensing Board did decide to "delay active and aggressive enforcement of licensure laws pertaining to debris removal and demolition for a period of 90 days, more particularly from September 1, 2005, through December 1, 2005."[16] The Board "did not take any aggressive action concerning enforcement of licensure laws during the 90 day suspension period . . ."[17] The suspension of enforcement was not absolute, and thus the licensing laws at issue remained valid statutory requirements, the enforcement of which was only temporarily relaxed.[18]

Accordingly, the Licensing Board's decision to loosen its enforcement of licensing requirements in the aftermath of the hurricane did not suspend the requirement that contractors be licensed in the state.[19] Consequently, many contractors still ran afoul of the license laws in the wake of Katrina. For example, in *Touro Infirmary v. Travelers Property and Casualty Company of*

[13]*See* La. Rev. Stat. Ann. §§ 37:2150 to 37:2151.

[14]Trade-Winds Environmental Restoration, Inc. v. Stewart, 2008 WL 236891 (E.D. La. 2008), aff'd, 409 Fed. Appx. 805 (5th Cir. 2011) (unpublished).

[15]2008 WL 236891.

[16]2008 WL 236891 at *3.

[17]2008 WL 236891 at *3.

[18]Tradewinds Environmental Restoration, Inc. v. St. Tammany Park, LLC, 578 F.3d 255, 261 (5th Cir. 2009).

[19]578 F.3d at 261.

America,[20] the Eastern District of Louisiana held that a contract to repair a hospital following damage from Hurricane Katrina was completely void because the contractor was not properly licensed in Louisiana.

Another example occurred in *Tradewinds Environmental Restoration, Inc. v. St. Tammany Park, LLC*.[21] There, an unlicensed contractor, Tradewinds, was hired to provide emergency mold remediation and restoration at an apartment complex following Hurricanes Katrina and Rita.[22] Tradewinds completed its contract work, but the owner of the apartment complex, STP, refused to pay the remainder of the bill.[23] Tradewinds filed a breach of contract action against STP to recover the balance due. The district court granted STP's motion for summary judgment, finding that Tradewinds provided mold remediation services in violation of Louisiana's licensing requirements. It held that the contract with STP was absolutely null, and Tradewinds could only recover the costs of the materials, services, and labor provided.

On appeal, the Fifth Circuit affirmed the district court's grant of summary judgment. It noted, "Louisiana courts have long recognized that statutory licensing requirements were enacted to protect an interest vital to the public order, and have relied on these Civil Code articles to invalidate contracting agreements entered into with unlicensed contractors."[24] Tradewinds was not licensed as a contractor or as a provider of mold remediation services at the time that it executed and performed the agreement with STP. Accordingly, the Court upheld the district court's conclusion that Louisiana's rule absolutely nullifying a contract entered into without the benefit of a contractor's license would limit Tradewinds' recovery to "the actual cost of materials, services and labor."[25]

From the foregoing, it is clear that a contractor wishing to perform work in another state, even in the case of a natural disaster, should proceed with caution and thoroughly research that state's licensing rules to ensure that it avoids penalties or lost contract funds.

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[20] Touro Infirmary v. Travelers Prop. Cas. Co. of America, 2008 WL 3975605 (E.D. La. 2008).

[21] Tradewinds Environmental Restoration, Inc. v. St. Tammany Park, LLC, 578 F.3d 255 (5th Cir. 2009).

[22] 578 F. 3d at 257.

[23] 578 F.3d at 258.

[24] 578 F.3d at 259.

[25] 578 F.3d at 260.

E. Solutions to the Licensing Dilemma at an Early Stage of a Project

The foregoing discussion outlines some of the main pitfalls and problems arising from failure to comply with state contractor license laws. Even when a prime contractor is properly licensed, however, additional problems can arise if it contracts with an unlicensed subcontractor. Once such a situation is discovered, the unlicensed subcontractor's work should be stopped immediately, or the general contractor will open itself up to claims of knowingly allowing an unlicensed contractor to perform work on a project. If the unlicensed contractor's scope is on the critical path of the project, the results can be devastating and may bring the entire project to a halt. Thus, any and all possible strategies for quickly resolving these issues must be explored.

One solution is to transfer the employees of the unlicensed subcontractor to the general contractor's payroll. While this may create additional difficulties on its own, the transferred employees would at least be able to continue work under the umbrella of a valid license. One caveat here is that the employees must be real employees, with W-2's. If this solution is unacceptable, however, the unlicensed subcontractor will likely have to be terminated and replaced as soon as possible.

Another possible solution would be to split up the subcontract of the unlicensed subcontractor so that it only supplies materials. The installation of those materials could then be performed by another (licensed) subcontractor. That way, the unlicensed subcontractor would not be performing any actual "construction" and would therefore not be required to possess a contractor's license.

F. A National Problem

In researching licensing problems across the nation, we came upon a very authoritative, if somewhat under-publicized, organization: the National Association of State Contractors Licensing Agencies.[26] NASCLA has published a compendium of state licensing statutes, which goes a long way toward helping the harried practitioner to identify proper contacts for licensing in various states.

How pervasive is enforcement of licensing statutes? The lack of

[26] Contact information for NASCLA:

National Association of State Contractors Licensing Agencies
23309 North 17th Drive, Building 1, Unit 110
Phoenix, AZ 85027
(623) 587-9519
website: www.nascla.org.

consistent disciplinary standards or procedures among states creates a skewed picture. Most states do not report statistics on the number of enforcement actions undertaken, but among those jurisdictions that do track and provide such information, the numbers are dramatic. Available records indicate that over the last five years, disciplinary proceedings have been undertaken as follows (remaining states provided no information):[27]

Alabama:	5
Alaska:	15
Arizona:	5,509
Arkansas:	49
California:	15,355
Florida:	370
Hawaii:	97
Idaho:	117
Louisiana:	183
Michigan:	272
Nevada:	1,516
North Carolina:	112
South Carolina:	19
Tennessee:	54
Texas:	17
Utah:	12
West Virginia:	3

II. Performing Work Before the Loan is Finalized

A. Introduction

One popular adaptation of the Golden Rule recites that: "He who has the gold, makes the rules." On many private construction jobs, the keeper of the coin is the bank or other lender providing the construction loan. Construction lending, particularly security for repayment of the loan, involves legal principles, strategies, and documents that consume entire treatises; certainly a much broader scope of information than is feasible to summarize in this article. However, virtually every construction lender starts by securing its loan with lien rights in the real property that is to be improved. The lender insists on being the first party to be paid, meaning that the lender's security interest on the owner's property must be recorded first in time, i.e., before anyone else, and without any chance that another party will be

[27] Source: National Association of State Contractors Licensing Agencies.

deemed to have superior rights in the real estate.[28] Most especially, the lender requires that no persons with competing lien rights may establish any part of those rights before the loan's security documents are recorded and thereby perfected.

The problem with a contractor beginning work before project financing has closed is that mechanic's lien rights are a huge concern to the lender. Construction lenders typically will not close (i.e., committing money for the work) without making certain that its security interest will take priority over all other liens. Typically, the lender inspects the property that is about to be improved. If it sees any signs of work having begun, it is likely to cancel the loan closing and instruct the title company not to record its documents. In other words, an over-eager contractor can jeopardize its own chances of getting paid by starting too soon. A terrible way to begin!

Mechanic's lien laws differ, sometimes significantly, among jurisdictions, and they are subject to very technical limitations or qualifications, which makes them difficult to summarize in a treatise, much less in a single article. Checking the law in your jurisdiction is mandatory, and given the fondness of legislators to change lien rights in response to lobbying by various interest groups, re-checking is recommended. Despite the variations between jurisdictions, some basic concepts seem to have general acceptance: breadth of scope for mechanic's liens; lien priority; and the relation back doctrine.

A wide variety of private projects are subject to a mechanic's lien, and equally broad are the activities that qualify parties, such as a contractor, subcontractor or laborer, to assert a lien:

> Construction, alteration, repair, demolition, or removal, in whole or in part, of, or addition to, a building, wharf, bridge, ditch, flume, aqueduct, well, tunnel, fence, machinery, railroad, or road.
> Filling, leveling, or grading real property.[29]

A comparatively small amount of work may trigger lien rights, such as placing markers in the ground to lay out a project.[30]

Generally speaking, the priority of a lien is depends upon the

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[28] Alternatively, if there is as pre-existing encumbrance, the construction lender may insist on an agreement of the previous creditor to subordinate its rights.

[29] Cal. Civ. Code § 8050(a) (2012).

[30] *See, e.g.*, Frank Pisano & Associates v. Taggart, 29 Cal. App. 3d 1, 105 Cal. Rptr. 414 (1st Dist. 1972). In contrast, temporary stakes for assisting in preparing a topographic map and plans for a proposed subdivision were not permanent works of improvement. South Bay Engineering Corp. v. Citizens Sav. & Loan Assn., 51 Cal. App. 3d 453, 124 Cal. Rptr. 221 (2d Dist. 1975).

date of recordation.[31] Mechanic's liens normally have priority over liens on a project recorded after commencement of the work of improvement.[32] Conversely, mechanic's liens usually are subordinate to deeds of trust (the usual security for a construction loan) and liens recorded before the start of construction.[33]

The relation back doctrine is widely observed, and it provides that a mechanic's lien filed at any point during the work or even after the project's completion "relates back" and therefore is deemed to have priority as of the day the work of improvement commenced.[34] Most importantly for our analysis in this article, if a construction lender records its deed of trust securing its loan to the project owner *after* the work of improvement has commenced, then lien rights for all of the work, by all of the contractors, subcontractors and laborers, among others, will be deemed to have lien priority over the deed of trust, even if some of the actual parties eventually filing liens were not onsite or performing work at the start of the project.[35]

Because lenders normally require that the deed of trust securing the loan be first in line for any payment, should the project come to a premature halt, the problem of work starting too soon (vis-à-vis the loan) becomes an issue affecting everyone involved. Quite simply, the lender will refuse to close its loan, rather than give priority to all the subcontractors, materialmen, and others normally eligible for mechanic's lien protection.

B. Preventive Solutions

Before plunging into what emergency measures to consider, we first note what should have been done to prevent the problem, through widely accepted "good practices" on job sites.[36] Bearing in mind that individual states differ in their lien laws, so one needs to confirm the availability of these approaches in the relevant jurisdiction, the recommended solutions to avoid premature work scuttling the construction loan involve the following:

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[31] *See, e.g.,* Cal. Civ. Code § 2897 (1872).

[32] *See, e.g.,* Cal. Civ. Code § 8450 (2012).

[33] *See, e.g.,* Oaks v. Weingartner, 105 Cal. App. 2d 598, 234 P.2d 194 (3d Dist. 1951).

[34] *See, e.g.,* Cal. Civ. Code § 8450 (2012); Schrader Iron Works, Inc. v. Lee, 26 Cal. App. 3d 621, 103 Cal. Rptr. 106 (1st Dist. 1972).

[35] *See, e.g.,* Santa Clara Land Title Co. v. Nowack & Associates, Inc., 226 Cal. App. 3d 1558, 277 Cal. Rptr. 497 (1st Dist. 1991). This broad principle assumes compliance with notice requirements and timing limitations for recording and filing suit.

[36] A good starting point would be chapter 4 (Pre-Construction Agreements) in Forms & Substance.

1. Limited Notice to Proceed with Non-Lienable Work

One possible way to proceed with some work, without automatically imperiling the financing, is for the owner to issue a limited notice to proceed (LNTP). In this situation, two factors should be kept in mind. First, any work needs to be off-site and cannot be shipped to the job. In other words, it must not create a basis for liening the project, which means that every precaution must be taken to prevent any unintended identification with the job, any permanent improvement to the site, and any right to file a lien. Language in the LNTP to restrict access needs to be clear, such as the following:

> Contractor acknowledges and agrees that Contractor shall not be authorized to proceed with any work other than the limited scope of services expressly set forth in (or reasonably inferable from the provisions of) this LNTP or otherwise approved by Owner in writing. Notwithstanding the generality of the foregoing or anything to the contrary herein, neither Contractor nor any other party performing on Contractor's behalf shall (a) access the Site, (b) deliver materials, equipment, or supplies, and/or (c) perform any Work at the Site.

Secondly, the LNTP's scope of work should be segregated from the basic contract; it would be best to use a separate contract, ideally with a different entity than the general contractor/construction manager responsible for the main project. A good approach would be to contract with a supplier directly to order long lead time equipment. The more that can be done to distinguish one contract from the other (different contractors, different project numbers, separate plans/specifications, and separate schedules), the less likely it is that the LNTP will be deemed the commencement of construction of the project as a whole.

Obviously, the safety of this solution is a matter of degree. The benefits of moving ahead with ordering long lead time equipment or scarce supplies is balanced against some risk that it could be construed as part of one single improvement, thus bootstrapping in lien rights for all subsequent parties working at the site. To avoid this problem (from the owner's standpoint), any LNTP should include an express reservation of the lender's ultimate priority, such as the following sample language:

> Notwithstanding anything to the contrary herein, neither Contractor nor any other party performing on Contractor's behalf shall perform any Work at the Site pursuant to this LNTP that would result in the "commencement of the Work of Improvement" or otherwise provide lien rights in the Site to any party. Contractor shall indemnify and hold harmless Owner and Title Company from and against any Liabilities, including but not limited to reasonable attorney's fees, arising or resulting from a violation of this

paragraph by Contractor or any party for whom Contractor is legally responsible.

2. Separate Contract for Early Work

With the agreement of the lender, a common solution is to start a limited amount of early work, such as creating a site road, clearing and grubbing, or basic demolition and site preparation, knowing that for this aspect of the project, lien rights will be created in advance of the financing. However, the goal is to prevent the rest of the project from treating the site preparation work as the commencement of the (single, unified) work of improvement. Like the limited notice to proceed, this requires a separate contract and as many distinguishing characteristics as possible (using a separate contractor is a definite plus). Unlike the LNTP for offsite work, there will be lien rights for the preliminary work.[37] The goals are to limit the amount of lienable work in advance of the construction loan (to the preliminary work itself), and to do so with lender cooperation and authorization. While many creative strategies exist, some lender requirement for security to take out any liens can be expected, such as a payment bond or a set-aside account posted by the owner, probably with the lender, to ensure payment and thus avoidance of any liens actually arising, at least ahead of the construction loan's deed of trust.

3. Prohibition of Any Advance Work on Site

Absent an LNTP or a separate site improvement contract, the owner at least should provide in its basic construction agreement that work may not commence without owner authorization. Such a clause would mean something if tied to a specific duty to indemnify against any damages for violating the limitation. A flow down clause, from the general contractor to its early stage subcontractors, would be another natural extension of this provision.

4. Escrow the Construction Agreement

One approach to avoiding a premature start to construction is to escrow the agreement between the owner and the contractor. In this "belt and suspenders" approach, the two parties separately sign counterparts of the agreement and deposit them into escrow, with instructions to the escrow agent to release and deliver the

[37] Liens specific to site improvements exist in some jurisdictions, often with priority over liens for the work of improvement itself. *See, e.g.,* Cal. Civ. Code §§ 8402 to 8404 (2012).

document upon satisfaction of a specific condition: closing of the construction loan.[38]

C. Non-Solutions

The reader may wonder why one should not require the general contractor, and through it, all the subcontractors, materialmen and suppliers, to waive their mechanic's lien rights, so that the lender need not worry about starting prematurely. While generalizations are hazardous because each jurisdiction has its own rules and body of lien law, the concise answer is that advance waivers of mechanic's lien rights are prohibited in many jurisdictions as against the public interest. In California, for example, the mechanic's lien laws are part of the state's constitution, and they cannot be substantially modified or waived in advance.[39] Thus, an "agreement" designed to modify the relation back doctrine, or to override the priority of liens for work performed ahead of the recording of a trust deed would run afoul of the strong public interest in many jurisdictions protecting "the little guys," subcontractors and laborers, in particular.[40]

Some states do permit advance waivers of statutory lien rights, and in those states construction lenders often demand that their borrowers secure waivers prior to financial closing. The challenge here may involve getting this done where the owner/borrower's only relationship is with a general contractor and it may have no idea who the subcontractors are, or their subcontractors and suppliers. Especially in a state where the "bootstrapping" of lien rights described above is possible, the risk of failing to identify and sign up a potential lien claimant can be troublesome.

An equally inappropriate "strategy" is to just hope that the lender does not notice. If nothing else (and lenders routinely verify site conditions before funding), an unpaid subcontractor insisting that its lien "trumps" the construction loan would wake up the construction lender. And lenders generally insist on own-

[38]For language and forms to accomplish this, see chapter 4 in *Forms & Substance*.

[39]*See, e.g.,* Cal. Civ. Code §§ 8122, 8126, 8132 to 8138, 8212, 8714, 8820, 8846 (2012). Such statutes generally reflect existing case law, and are enforced. *See, e.g.,* Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal. 4th 882, 64 Cal. Rptr. 2d 578, 938 P.2d 372 (1997).

[40]Subordination to a loan agreement, when it closes and with consideration for the change in priority, could be negotiated, but that differs from advance waiver of rights. Lenders may require subordination agreements from all known project participants as a condition of loan closing, and often the fact that without a closing no project will be built is sufficient to induce parties to acquiesce; as with waivers, discussed above, this strategy requires complete identification of all potential lien claimants in order to succeed. Subordination is discussed further below.

ers keeping the job lien free and indemnifying them for any losses. The ruse would simply come back to haunt the owner or general contractor that takes a head-in-the-sand approach.

D. Emergency Procedures

What should be done if, despite this cautionary tale, the problem occurs anyway, and your client's boat has struck a rock as it is trying to leave the harbor? There are no easy, casual solutions, but with hard work and quick reactions to confront the problem, the ship can often be repaired and the journey can continue, albeit with delay and extra expense.

1. Title Company/Bond

Two methods should be considered before more drastic steps may be appropriate. A title company may "insure over" or provide an endorsement allowing the project to proceed because the title company will take the risk that a lien will be filed and will have statutory priority over the trust deed it is insuring. This solution requires prompt notice to the title insurer, a very creditworthy indemnitor to back up the insurance company's risk, and a budget that withstands the scrutiny of the title company (now extra cautious about reserves and loan payment controls). One cannot count on such actions, but they still occur and can quickly put the project back on course.

Alternatively, some jurisdictions allow the posting of a payment bond, as an alternative security, which effectively protects the deed of trust's priority as to liens for work, equipment and materials provided after the bond has been recorded.[41] Such a payment bond, at least in some jurisdictions, offers no protection against liens that may arise from work provided before recording of the bond (i.e., the early work that "jumped the gun" in the first place), but at least the bond works to prevent the relation back doctrine from leapfrogging all lienable work ahead of the construction lender. The bond typically needs to be large (75% of the principal amount of the construction loan, in California), and therefore will be expensive and hard to obtain.

2. Post-Commencement Subordination Agreement

Another alternative approach is for a lien holder to subordinate its lien to that of the project lender. Of course, the subordination by a general contractor would not affect its subcontractors. And each of the subcontractors would need to subordinate its own lien rights before the lender might be comfortable in proceeding. This would be very difficult to orchestrate, but clearly worth the effort if everyone is cooperative (and sees its own position enhanced by the project not foundering).

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[41] *See, e.g.,* Cal. Civ. Code § 8452 (2012).

3. Change Order/Termination

The most drastic courses of action, which nevertheless may be necessary, are to negotiate a deductive change order to remove all work not yet begun, or simply to terminate the remaining work of the unlicensed contractor. The general plan would be to resume the work, once funding has closed and a new contract is in place. Of course, no one wants to shut down the project and incur the expense and delay of re-starting, but the construction lender may leave the owner with no other realistic choice. These "abandon ship" options still run some risk—beyond all of the extra costs and delays—that they would be seen as a subterfuge to avoid giving the future lien holders priority over the lender. Realistically, however, they may be the only courses available (and will be a challenge, anyway).

With these last two options, the owner will need to finish the premature work in some manner, and clear up any liens, before contemplating closing with the lender and recording a deed of trust.

III. Failure of Financing at the Start of the Project

A. Introduction

Failure of financing is not a complete disaster, but it is close. The survival of the project depends on the reason no money or not enough money is available. Bankruptcy, receivership, and banking system paralysis are examples of failures that leave no hope for an immediate or even near-term "righting of the ship." However, a "mere" out of balance loan, or "only" the refusal of the lender to proceed, due to project budget concerns, offers at least some hope of salvage and future progress. As the construction lawyer knows, passage will not be comfortable, and all aboard will need to sacrifice and cooperate, not mutiny or fight over the flotsam of the project.

B. Preventive Solution(s)

It is helpful to review, quickly, contractual solutions that might have saved the ship from the peril in the first place. Most importantly, at least for the contractor, is the clause increasingly found in owner-contractor agreements that allow the builder access to the owner's financial information. For example, the American Institute of Architects' A201 General Conditions includes the following:

> Prior to commencement of the Work, the Contractor may request in writing that the Owner provide reasonable evidence that the Owner has made financial arrangements to fulfill the Owner's obligations under the Contract. Thereafter, the Contractor may only request such evidence if (1) the Owner fails to make payments to the Contractor as the Contract Documents require; (2) a change in the

> Work materially changes the Contract Sum; or (3) the Contractor identifies in writing a reasonable concern regarding the Owner's ability to make payment when due. The Owner shall furnish such evidence as a condition precedent to commencement or continuation of the Work or the portion of the Work affected by a material change. After the Owner furnishes the evidence, the Owner shall not materially vary such financial arrangements without prior notice to the Contractor.[42]

Section 2.2.1 has received a good deal of attention, as did its predecessor in the A201 from 1997. It strikes a balance of interests between privacy concerns for the owner and payment concerns for the contractor:

> The section recognizes both the legitimate concerns of a Contractor as to the Owner's ability to pay and of an Owner as to the Contractor's possibly abusive use of it rights. On one hand, this provision implicitly recognizes that a common cause of Project failure and/or litigation is an insufficiently funded Owner. Many private projects are owned by a specially created LLC whose only asset is the property to be improved, financed up to a maximum amount by a lender holding a first-lien security interest. If the Project costs exceed the financing maximum (due to unforeseen site conditions, changes and extras required by local authorities, Owner modifications, etc.), the Owner's ability to pay may be compromised. On the other hand, the provision recognizes that Owners have legitimate concerns that some Contractors might abuse their financial verification rights mid-project by threatening to stop work if certain demands unrelated to the Owner's ability to pay were not met.[43]

Under the terms of Section 2.2.1, and similar language in other agreements, the contractor need not start work or continue with it, if the owner's "reasonable evidence" is insufficient. This clause, therefore, should expose the problem before work actually begins, or before more work is expended once an unexpected (and unbudgeted) condition is encountered.

Consistent with Section 2.2.1, the contractor may terminate the contract if its work is "stopped for a period of 30 consecutive days" because "the owner has failed to furnish to the Contractor promptly, upon the Contractor's request, reasonable evidence as required by Section 2.2.1."[44] This reinforces the contractor's ability not to proceed with the Work, or to continue with it, if there is not reasonable evidence provided. That amounts to a right of suspension, which within 30 days may become a termination.

Naturally, notice of failure to provide "reasonable evidence" is

[42] AIA Document A201, General Conditions of the Contract For Construction (2007) [hereafter A201—2007], § 2.2.1.

[43] A. Holt Gwyn, Charles M. Sink, Dean B. Thompson & James D. O'Connor, The 2007 A201 Deskbook at 22 (ABA 2008).

[44] A201—2007, §§ 14.1.1, 14.1.1.4.

important. While no direct right exists for subcontractors to demand such financial information, they at least should negotiate a "flow down" provision allowing them to suspend work, if the contractor is refused this reasonable evidence, or if it asserts that such evidence as was provided shows insufficient funds on hand for the project.

C. Non-Solutions

Generally, work grinds to a halt when the money runs out or its flow is suspended. Like any construction site problem, lack of money normally does not disappear or improve with neglect. The vigilant construction counsel will want to set the project aright, not let it founder or drift. In short, doing nothing is not a valid option. The lawyer needs to help the parties develop a plan moving forward, starting with how to keep the project from sinking immediately.

D. Emergency Procedures

Putting aside a catastrophic failure of financing, such as the owner's bankruptcy, an appointment of a receiver for the project, or a major spike in interest rates or a credit freeze such that no financing is available at rates that make the project "pencil out," which are perils that do not lend themselves to an immediate solution, the resourceful lawyer will want to facilitate an infusion of additional capital or a down-sizing of the project so that conventional financing can be restored (or established for the first time).

Assume that financing has failed because the project's costs no longer fit within the lender's loan to value ratio, or because the project budget (set as part of the lending process) suddenly is out of balance. For example, the initial grading work reveals soils issues that will greatly increase the cost of the foundation, beyond the project's allowances or contingencies. Or, in the project "buy out" (negotiation and signing of subcontracts), a major cost increase is discovered, putting the price of the work beyond any available financing. The construction lawyer needs to assist his or her client in getting the project back afloat.

One solution, well within the construction lawyer's usual experience and expertise, is to assist the parties in value engineering the work so that it fits back within the bank's budget, while preserving the value of the completed project so that the lender is comfortable that it will be protected at the end of construction. Some owner-designer agreements require the architect or engineer to redesign the project to fit the owner's budget. If no such provision exists, then an addendum to the designer's contract, prepared by counsel, can move the project back on course. The principal drafting risk involves clearly assigning

responsibility so that the redesigned project actually meets the budget (the process likely will require the owner's cooperation with alternatives that it does not like, and the contractor's interaction with the designer, to avoid more disappointment).

An alternative, again requiring the resources of construction counsel, is to renegotiate the size of the project and the amount of construction financing to build it. Generally, this means making do with less (paring down the scope of the Work, while reducing the amount borrowed so as to finally bring the two into balance). The construction agreement almost certainly will require a deductive change order, with careful documentation of what has been removed and what that does to the overhead and profit in the scope of work.

For those projects that cannot be slimmed down, the owner's lawyer must turn attention to assisting the client's efforts to raise more funds. An added equity investment would be the lender's usual first choice. The possibilities are many, and include renegotiations with the owner to reduce or eliminate its draw downs against the loan (in effect, requiring it to put more equity into the project, perhaps by foregoing reimbursement for the land acquisition or for pre-construction expenses, such as design work, already performed). An added investor and increased capital often represents the only realistic course in keeping the project afloat.

IV. Disappointed Bidder's Suit

A. Introduction

The advent of a bid dispute can mean real trouble for any construction project. In certain circumstances, a disappointed bidder on a state or federal project can potentially shut down the entire project before it even starts. Because bid disputes can have such drastic effects on construction projects, it is important to understand the bid dispute process. A bid dispute generally starts from the moment the bids are opened and is unlikely to end unless the disappointed bidder loses its protest, the project shuts down, or a court orders that the public body award the project to the disappointed bidder. Bid disputes create risks of injunction and disgorgement, add to the costs of the project, and in some instances, can even shut down the project entirely.

Bid disputes can arise on any government-run project, whether the project is state or federal. However, the process and applicable rules involved in the bid dispute will differ depending on whether the project is federal or state-owned. Further, because most states have established their own bodies of laws to govern public bidding and bid disputes, the applicable rules can vary from state to state.

B. Effects Bid Disputes Can Have on Construction Projects

As noted, the onset of a bid protest can mean the end of a construction project. In some federal forums, project work can continue if there is a government necessity, but the same may not be true for state projects. Thus, an unhappy bidder can file a protest that stops a project, and that stoppage may continue to a point when the project is no longer viable.

This exact situation occurred in *Broadmoor, L.L.C. v. Ernest N. Morial New Orleans Exhibition Hall Authority*.[45] There, a disappointed bidder filed a protest action regarding the award of a contract for a phase of construction for the Ernest N. Morial Convention Center in New Orleans. A preliminary injunction was refused by the trial court, but granted by the appellate court, and the Louisiana Supreme Court upheld the appellate court's decision, siding with the bid protestor. However, by the time all of the issues with the bid protest were worked out, Katrina struck New Orleans in August 2005, and the City of New Orleans decided thereafter that the convention center project, worth approximately $250 million, was no longer necessary. As a result, the project was never started.

The difference between most public bid disputes and federal bid disputes is that the federal bid dispute will not always hold up the start of the construction of a project. This is not the case in Louisiana and most other states. While bid disputes are typically heard on petitions for preliminary injunctions and technically should be heard within several weeks, that is almost never the case.

How can a project make progress if a preliminary injunction is in place, and the project cannot move forward sometimes for over a year? One method the authors have employed when representing the low bidder is to negotiate to give a portion of the contract, by way of subcontract, to an aggrieved competitor. The trick is to make sure there is still enough profit in the job for the low bidder, as well as for the aggrieved second bidder. This works out particularly well on highway projects where the work can often be easily divided up.

C. Bid Dispute Processes

1. Bid Disputes on Federal Projects

a. Introduction

A disappointed bidder on a federal project is provided with sev-

[45]Broadmoor, L.L.C. v. Ernest N. Morial New Orleans Exhibition Hall Authority, 867 So. 2d 651 (La. 2004).

eral vehicles for contesting an award or the failure to award a federal contract. The main avenues for asserting such a claim include:

1. Filing a protest with the relevant government agency;
2. Submitting a claim to the U.S. Government Accountability Office ("GAO"); or
3. Filing suit in the Court of Federal Claims ("COFC").

Each avenue is governed by its own set of rules and has its own advantages and disadvantages.

b. Protests before the Relevant Agency

The Code of Federal Regulations ("CFR") encourages disappointed bidders to first seek resolution at the agency level.[46] The procedures for agency protests are generally contained in Chapter 33 of the CFR, which rules illustrate a desire to resolve bid disputes in a simple, swift, and straightforward manner. Thus, 48 C.F.R. § 33.103(c) suggests that the relevant federal agency "provide for inexpensive, informal, procedurally simple, and expeditious resolution of protests" and that other dispute resolution procedures be considered and used if necessary. Generally speaking, an agency level protest is the fastest and cheapest manner for protesting federal bids. However, because such disputes are before the agency which already awarded the contract that is at issue, some may elect to use a more "independent" forum.

Agency protests are subject to certain time limitations. Protests must be filed "before bid opening or the closing date for receipt of proposals" and "in all other cases, . . . no later than 10 days after the basis of protest is known, . . . whichever is earlier."[47] However, even late-filed protests can be considered by the agency if "good cause [is] shown" and the agency "determines that a protest raises issues significant to the agency's acquisition system."[48]

Once a protest is received pre-award, the agency is generally required to withhold the award of the relevant contract pending the resolution of the protest.[49] Further, if the protest is received within 10 days of the award of the contract or within five days of the designated debriefing date, whichever is later, the contracting officer is required to suspend performance of the contract

[46] 48 C.F.R. § 33.102(e) ("An interested party wishing to protest is encouraged to seek resolution within the agency (see 33.103) before filing a protest with the GAO, but may protest to the GAO in accordance with GAO regulations (4 CFR part 21).").

[47] 48 C.F.R. § 33.103(e).

[48] 48 C.F.R. § 33.103(e).

[49] 48 C.F.R. § 33.103(f)(1).

until the protest is resolved.[50] Thus, the entire project could be placed on hold pending resolution of the bid dispute. Despite the foregoing, the agency may still award the contract if the award "is justified, in writing, for urgent and compelling reasons, or is determined, in writing, to be in the best interest of the Government."[51] This prevents important projects from being derailed by a bid protest.

If, after reviewing the protest, the agency determines that the protest is meritorious, the agency may "[t]ake any action that could have been recommended by the Comptroller General had the protest been filed with the" GAO.[52] The remedies available to the GAO include not exercising options under the contract, terminating the contract, re-competing the contract, issuing a new solicitation for bids, awarding the contract consistent with a statute and regulation, or any other recommendation which the "GAO determines necessary to promote compliance."[53]

c. Protests Before the Government Accountability Office

The GAO defines itself as "an independent, nonpartisan agency that works for Congress. Often called the 'congressional watchdog,' GAO investigates how the federal government spends taxpayer dollars."[54] Disputes brought before the GAO are heard by GAO staff attorneys, who generally have experience with government procurement law. The protest procedure before the GAO is more formal than an agency protest. However, a significant consideration to understand before choosing the GAO is that, technically, the GAO has no actual ability to force the relevant government agency to adopt its recommendations. Despite the GAO's lack of ability to enforce its recommendations, they are often accepted.

Protests based on "alleged improprieties in solicitation which are apparent prior to the bid opening or the time set for receipt of initial proposals" must be filed "prior to bid opening or the time for receipt of initial proposals."[55] A protester alleging impropriety in the solicitation of the bid which fails to submit a protest prior to the bid opening waives the right to a GAO protest.

Any other types of protests must be "filed no later than 10 days after the basis of the protest is known or should have been known

[50] 48 C.F.R. § 33.103(f)(3).

[51] 48 C.F.R. § 33.103(f)(3).

[52] 48 C.F.R. § 33.102.

[53] 4 C.F.R. § 21.8.

[54] "About GAO," http://www.gao.gov/about/ (last visited April 2015).

[55] 4 C.F.R. § 21.2(a)(1).

(whichever is earlier)."[56] If a protester previously filed a timely agency protest, the protestor must file a subsequent protest with the GAO "within 10 days of actual or constructive knowledge of initial adverse agency action."[57] The GAO may dismiss any protest that is untimely on its face.[58] Nevertheless, the GAO is able to consider tardy protests if good cause is shown or if "it determines that a protest raises issues significant to the procurement system."[59]

If a protest is timely filed with the GAO before the award of the contract, the GAO is able to require the relevant agency to stay the award of the contract until the protest is decided.[60] The suspension of the award of the contract will only be effective from the time when notice is provided by the GAO of the protest and not by the individual protestor.[61] Thus, when protests are filed either with the relevant agency or the GAO, mechanisms are in place that can force the agency to suspend the award of the contract until the protest is decided.

Once the GAO determines that a violation of statute or regulation has occurred, it may recommend agency actions such as not exercising options under the contract, terminating the contract (if awarded), "recompeting" the contract, issuing a new solicitation for bids, awarding a contract which would be consistent with statute and regulation, or any other course of action that the "GAO determines necessary to promote compliance."[62] When determining what recommendation it will issue, the GAO is to:

> [c]onsider all circumstances surrounding the procurement or proposed procurement including the seriousness of the procurement deficiency, the degree of prejudice to other parties or to the integrity of the competitive procurement system, the good faith of the parties, the extent of performance, the cost to the government, the urgency of the procurement, and the impact of the recommendation(s) on the agency's mission.[63]

d. Protests before the Court of Federal Claims

The final main avenue for federal bid protests is before the

[56] 4 C.F.R. § 21.2(a)(2).

[57] 4 C.F.R. § 21.2(a)(3).

[58] 4 C.F.R. § 21.2(b).

[59] 4 C.F.R. § 21.2(c).

[60] 4 C.F.R. § 21.6. An exception is recognized to the stay requirement for certain urgent circumstances. 31 U.S.C.A. § 3553.

[61] Information Resources Inc. v. U.S., 676 F. Supp. 293, 296, 34 Cont. Cas. Fed. (CCH) P 75357 (D.D.C. 1987).

[62] 4 C.F.R. § 21.8.

[63] 4 C.F.R. § 21.8(b).

COFC. Pursuant to 28 U.S.C.A. § 1491, the COFC is vested with the jurisdiction:

> to render judgment on an action by an interested party objecting to a solicitation by a Federal agency for bids or proposals for a proposed contract or to a proposed award or the award of a contract or any alleged violation of statute or regulation in connection with a procurement or a proposed procurement.

The COFC is the most formal, complicated, and time-consuming forum for bid protests. Further, there is no automatic mechanism for the stay of a contract award. "The Rules of the [COFC] generally mirror the Federal Rules of Civil Procedure,"[64] so the rules and procedures employed in the COFC should be familiar to those who have handled a normal district court case.

In order to preserve a protest claim before the COFC, "a party who has the opportunity to object to the terms of a government solicitation containing a patent error and fails to do so prior to the close of the bidding process waives its ability to raise the same objection subsequently in a bid protest action in the Court of Federal Claims."[65] A bidder having knowledge of a violation before the contract has been awarded must object as soon as possible to preserve its protest.

Once the COFC determines that a bid protest is valid, it "may award any relief" that it "considers proper, including declaratory and injunctive relief except that any monetary relief shall be limited to bid preparation and proposal costs."[66] However, as previously noted, unlike in a protest before the agency or the GAO, there is no automatic stay employed when a protest action is brought before the COFC. Thus, protestors are required to seek injunctive relief if they wish to stay the award of a contract. The COFC has set forth the following factors to consider when deciding to grant an injunction:

1. The plaintiff has succeeded on the merits;
2. The plaintiff will suffer irreparable harm if the court withholds injunctive relief;
3. The balance of hardship to the respective parties favors the grant of injunctive relief; and

[64] Cohen v. U.S., 100 Fed. Cl. 461, 469 n.3 (2011), affirmed, 528 Fed. Appx. 996 (Fed. Cir. 2013); *see also* Patton v. Secretary of Dept. of Health and Human Services, 25 F.3d 1021, 1025 n.4, 29 Fed. R. Serv. 3d 682 (Fed. Cir. 1994).

[65] Blue & Gold Fleet, L.P. v. U.S., 492 F.3d 1308, 1313 (Fed. Cir. 2007).

[66] 28 U.S.C.A. § 1491(b)(2).

4. The public interest is service by a grant of injunctive relief.[67]

2. State-level bid protests

Just as the federal system has its own bid dispute process, many states have enacted their own laws to govern bid disputes for state projects. The process for disputing a bid will differ from state to state, so it is important to examine the relevant state's laws to ensure that all requirements are met.

No matter which state is involved, the origin of bid dispute litigation begins with the opening of the bids. Generally, the bids will be read and the contract will be awarded to the lowest responsible bidder. However, in some cases, the public body may decide to reject the apparent low bid because it did not comply with the bid documents and is therefore considered "non-responsive." While public bodies are generally required to enter into the relevant contract with the lowest responsible bidder, an exception exists if entering into that contract would violate that state's public bid law.[68] Because bids are generally considered public records, any contractor is entitled to review the original bids.

It is the responsibility of the disappointed bidder to take affirmative action to compel the award of the contract. Many states do not have an agency in place to hear the bid protest, so an aggrieved bidder must go to court to prevent the award of a bid to the allegedly non-responsive bidder. In such cases, the aggrieved bidder is encouraged to move as quickly as possible and seek an injunction barring the award of the contract to the non-responsive bidder. If action is not quickly taken, as noted above, the project could proceed and the aggrieved bidder could lose its opportunity to obtain the award of the contract.

V. Performing Work Before the Surety Bonds are in Place

It is not unusual for general contracts and subcontracts to provide that the contractor or subcontractor will provide performance and payment bonds to the owner or to the general contractor.[69] On federal jobs, bonding is mandatory for general

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[67] Contracting, Consulting, Engineering LLC v. U.S., 104 Fed. Cl. 334, 341 (2012) quoting Centech Group, Inc. v. U.S., 554 F.3d 1029, 1037 (Fed. Cir. 2009).

[68] *See* Broadmoor, L.L.C. v. Ernest N. Morial New Orleans Exhibition Hall Authority, 867 So. 2d 651 (La. 2004).

[69] William Schwartzkopf & John J. McNamara, Calculating Construction Damages § 5.02 (2d. Ed. 2000) ("Virtually all public and many private contracts require that a contractor provide bonds to the owner guaranteeing performance of the contract and payment to subcontractors and suppliers.").

contractors pursuant to the Miller Act.[70] Virtually all state public works contracts over a certain threshold amount in the United States require performance and payment bonds, often pursuant to statutes referred to as "little Miller Acts."[71] It is also common on large private projects for surety bonds to be required by the general contractor, and in turn the general contractor typically requires those from its subcontractors. What happens when the subcontractor cannot provide a bond, or begins work before bonds are in place? This can cause a number of different problems:

A. Waiver

There are cases that have held that allowing a subcontractor to begin work before bonds are provided might be construed as a waiver of the obligation to provide performance and payment bonds.[72] Failure to provide a performance and payment bond would in other instances be considered a breach of contract, but that breach could be waived by the owner or general contractor allowing work to proceed without bonding.

B. Alternatives to Bonding if Work Has Already Started

A surety may be reluctant to issue a bond once work has begun, or at least to bond the work already performed. There are alternatives that can be used early on in the job to salvage the security that would otherwise be provided for a bond. These are as follows:

a. **Personal guaranty** of the contractors, officers, and owners. This sounds better than it is, since if the contractor is not able to get bonding, its personal guaranty may be of dubious value. Nev-

[70] 40 U.S.C.A. § 3131.

[71] U.S. v. Pace, 201 F.3d 1116, 1117–18 (9th Cir. 2000) (". . . the Miller Act requires contractors on federal projects to purchase bonds securing the laborers and material men. States generally have 'little Miller Acts' doing the same thing for state and local construction."); *see also* Murdock & Sons Const., Inc. v. Goheen General Const., Inc., 2002 WL 243576, *10 (S.D. Ind. 2002) (citing Hasse Contracting Co., Inc. v. KBK Financial, Inc., 1999-NMSC-023, 127 N.M. 316, 980 P.2d 641, 644, 38 U.C.C. Rep. Serv. 2d 1027 (1999); Syro Steel Co. v. Eagle Const. Co., Inc., 319 S.C. 180, 460 S.E.2d 371, 373 (1995); McClure Estimating Co. v. H.G. Reynolds Co., Inc., 136 N.C. App. 176, 523 S.E.2d 144, 149 (1999)).

[72] T.G.I. East Coast Const. Corp. v. Fireman's Fund Ins. Co., 600 F. Supp. 178, 181 (S.D. N.Y. 1985) (citing Sehlbert Mechanical Corp. v. Kessel/Duff Const. Corp., 79 A.D.2d 680, 433 N.Y.S.2d 866 (2d Dep't 1980); Hevenor v. Union Ry. Co. of New York City, 204 A.D. 535, 198 N.Y.S. 409 (1st Dep't 1923)) (Stating that "[a] requirement in a subcontract that the subcontractor provide bonding is waived by the contractor if he knowingly permits the subcontractor to proceed with the work unbonded . . . The waiver is implied by law because the conduct of the contractor is inconsistent with an intent to enforce his rights.").

ertheless, it does give the contractor additional incentive to finish the project.

b. **Letters of credit**. Letters of credit can be an alternative to bonding early in the job and could be obtained in amounts considerably less than the amount of the performance and payment bond. This would be especially true with payment bonds, where a 100% bond is typically not necessary to secure the general contractor and the owner. The problem with a letter of credit, much like that of the personal guaranty, is that the contractor unable to obtain bonding probably has insufficient credit to obtain a letter from its bank.

c. **Joint check arrangements**. Very often a contractor will be required to subcontract a considerable amount of work to Disadvantaged Business Enterprises ("DBE's") in order to satisfy certain goals on a project. Those DBE's may in many instances have difficult times obtaining traditional bonding. In many instances, it has been the authors' experience that general contractors will work with DBE's by way of joint check arrangements, guaranteeing their subcontractors and suppliers will be jointly paid along with the DBE, thereby obviating the necessity for the additional security that would be provided by a payment bond.

With regard to DBE's, an additional problem that can occur early on in the job is that a DBE may in fact not have bonding capacity and thus fails to provide a bond with the result that it is technically in breach of the contract. Terminating DBE's at the beginning of a job is a touchy situation, and in many instances, the public owner requires that the general contractor go through a lengthy process to do so,[73] often requiring that the general contractor replace the DBE with another certified DBE. While this may not be a difficult process if the contractor has several months of lead time, when this happens early in the job, it can be a disaster.

d. **Subguard Insurance**. Subcontractor default insurance, often referred to as "Subguard"[74] or "default insurance," can also be used as an alternative where the subcontractor cannot get bonding, and begins work before bonds are provided. Subguard can be helpful on projects where bonding is difficult or impossible

[73] 49 C.F.R. § 26.53; Bruner & O'Connor on Construction Law § 2:55.56 [hereafter "Bruner & O'Connor"] ("When a DBE subcontractor fails to complete the work on a contract for any reason, a prime contractor must make good faith efforts to find another DBE subcontractor to substitute for the original DBE. The DBE substitute shall perform at least the same amount of work under the contract as the DBE that was terminated.").

[74] "Subguard" is a registered trademark of Zurich Services Corporation. Here, it is used to refer both to the Zurich product and more generally to subcontractor default insurance.

to obtain. It can be purchased by an owner to cover the defaults of the general contractor and its subcontractors or by a general contractor to cover the defaults of its subcontractors.[75]

Subguard insurance places the liability for a defaulting subcontractor upon the insurance company; thus, if a default occurs, the insurer will pay the insured for the default. Further, the payment is not restricted by the subcontract amount, but only by the policy limit. Because the policy requires payment within a certain time period, or in some cases an advance payment, if a default occurs, swift action is generally taken by the insurer. Nevertheless, if coverage is triggered, unlike in the bonding scenario, a deductible will have to be paid by the insured.

Importantly, rather than issuing a policy insuring each individual subcontractor, in the Subguard relationship, one policy generally covers all subcontractors on a given project. Further, such a policy will commonly provide coverage for both first and second-tier subcontractors. Because Subguard provides coverage for a large portion of the overall project, rather than a single contractor—as is the case with surety bonds—some may find Subguard advantageous from a "big picture" point of view. Subguard insurance generally covers the following damages:

1. Completion costs created by defaulting subcontractors;
2. Correction costs for defective/non-conforming work;
3. Legal costs resulting from default;
4. Investigation and adjustment costs; and
5. Indirect default costs, including extended overhead, job acceleration and certain liquidated damages.[76]

A Subguard policy will normally be triggered upon a subcontractor's default, which is generally defined "as a failure to fulfill the terms of its subcontract."[77]

One important practical difference between the surety and the Subguard relationship is that when a Subguard policy is issued, the onus is placed upon the contractor to investigate the fiscal viability of its subcontractor. However, before a bond is issued, the surety will thoroughly investigate the relevant subcontractor to determine its fiscal viability and ability to complete the relevant contract. Further, unlike surety bonds that generally last for the life of the contract, a Subguard policy generally has a policy time limit.

[75]Gray, Point/Counterpoint: Default Insurance—An Alternative to Traditional Surety Bonds, 22 Constr. Law. 17 (Winter 2002).

[76]Gray, Point/Counterpoint: Default Insurance—An Alternative to Traditional Surety Bonds, 22 Constr. Law. 17 (Winter 2002); *see also* Bruner & O'Connor on Construction Law § 11:317.

[77]Bruner & O'Connor on Construction Law § 11:317.

A traditional surety lawyer will likely advise that Subguard does not provide the protection to the owner or general contractor that is provided by traditional bonding, but in some instances may be all that is available.

VI. Performing Work Before Insurance is Provided

A. Introduction

Insurance is required on virtually all projects. Sometimes it is provided by contractors at multiple tiers. On other jobs it is provided as part of a consolidated owner-controlled insurance program (OCIP) or contractor-controlled insurance program (CCIP). A failure to obtain required coverage creates uninsured exposures, not to mention that it frequently constitutes a breach of the construction or design agreement.

Generally, contractors, subcontractors, design professionals, and even owners carry on-going insurance, which is not specific to a particular project. Commercial general liability insurance ("CGL"), for example, protects against bodily injury or property damage without reference to a particular project. It is extremely common, as is property insurance carried by a property owner. Similarly, an architect or engineer normally carries errors and omissions coverage to protect the business from claims of professional malpractice. Thus, the parties to a construction project already are insured because they are functioning businesses that carry insurance before, during and after commencing the work in question. The problem of starting work before insurance is provided generally refers to coverage specific to a project. Project-specific policies in this context refer to the following types of insurance or endorsements.

Builder's risk, which covers damage to the project itself, is a form of property insurance (and is "first party" coverage, meaning it does not insure against claims against a party but rather against damage to a party's property). Ordinarily, builder's risk would be purchased by the owner, but failing that, the contractor could buy it because the risk of fire or other perils destroying a partially built project is substantial and the effect would be catastrophic to a job (or because the owner contractually shifts the obligation to the contractor). This insurance is meant to pay for the work of restoring the project to the stage it was when the event took place. The contractor certainly does not want to be financially responsible for rebuilding the project just because lightning struck and burned it to the ground. Failure to buy this insurance, because of the potential loss, represents a very real concern to the owner and the contractor in particular.

While CGL coverage for the owner and contractor often exist independently of the job, many owners typically require the

contractor to add them to the contractor's CGL policy as additional insureds. For that matter, most contractors do the same to their subcontractors. Each of these project participants comes to depend on insurance of others picking up the risks of claims arising from a particular project. Most construction contracts and subcontracts require the contractor and subcontractors (respectively) to add the owner and contractor as additional insured before their work begins. Typically, the time between signing the contract and actual work commencing is when additional insured endorsements are sought and must be provided. When they are not, or when they are late, the party expecting protection may well halt the work of the offending contractor or subcontractor, and thereby hold up the job, until the endorsement is handed over.

The problem also can arise when a project specific policy is to be provided by the owner or the contractor. An owner controlled insurance program, OCIP, and a contractor controlled insurance program, CCIP, are designed to protect virtually all of the parties to a designated project. If work begins before that program is in place, then there may be a gap in coverage, leading to excessive exposure to claims for bodily injury, property damage, workers' compensation, and a host of other perils.

B. Preventive Solutions

It is important to define the insurance requirements in the construction contracts clearly at the outset of any project, taking into account the unique needs of the project, the products available in the current market, and their cost.

Standard form construction agreements uniformly provide for insurance, although they also leave to the parties to set the specific limits of coverage (and the parties are free to add or subtract specific types of insurance). The ConsensusDocs 200 and the AIA's A201 General Conditions both include checklists of standard coverages to prompt the parties into thinking about what insurance they actually need and want for their project.[78] Failure to obtain and maintain the required insurance (and at the designated limits) represents a breach of contract.

The AIA A201—2007 is typical:

> The Contractor shall purchase from and maintain in a company or companies lawfully authorized to do business in the jurisdiction in which the Project is located such insurance as will protect the Contractor from claims set forth below which may arise out of or

[78] ConsensusDocs 200, Standard Agreement and General Conditions Between Owner and Constructor (2012) § 10.2, for example, deals with third-party claims for property damage or bodily injury; A201—2007, article 11, likewise addresses insurance.

> result from the Contractor's operations and completed operations under the Contract and for which the Contractor may be legally liable, whether such operations be by the Contractor or by a Subcontractor or by anyone directly or indirectly employed by any of them, or by anyone for whose acts any of them may be liable.[79]

These coverages must be maintained:

> The insurance required by Section 11.1.1 shall be written for not less than limits of liability specified in the Contract Documents . . .. Coverages, whether written on an occurrence or claims-made basis, shall be maintained without interruption from the date of commencement of the Work until the date of final payment and termination . . . or for such other period for maintenance of completed operations coverage as specified in the Contract Documents.[80]

Standard form agreements routinely require insurance before the Work starts:

> Certificates of insurance acceptable to the Owner shall be filed with the Owner prior to commencement of the Work and thereafter upon renewal or replacement of each required policy of insurance.[81]

Form contracts require similar compliance by the owner, especially as to builder's risk or property insurance that covers the work in question:

> Unless otherwise provided, the Owner shall purchase and maintain . . . property insurance written on a builder's risk "all risk" or equivalent policy form in the amount of the initial Contract Sum, plus value of subsequent Contract Modifications and cost of materials supplied or installed by others, comprising total value for the entire Project at the site on a replacement cost basis without optional deductibles.[82]

Results will be greatly improved by taking a few additional steps both at the beginning and throughout the project to ensure that the insurance which was so carefully designed and specified is available when something goes wrong. The steps described below are essential to securing the best possible return on the insurance investment.

1. Getting Certificates and Policies Before a Problem Arises

The easiest time to get the most complete information to prove that the project participants have actually received the type and extent of insurance coverage required is at the beginning of the project, before something goes wrong and a claim arises. In the

[79] A201—2007 § 11.1.1

[80] A201—2007 § 11.1.2.

[81] A201—2007 § 11.1.3.

[82] A201—2007 § 11.3.1.

traditional project, not covered by an OCIP or CCIP, where each project participant gets, and is required to produce evidence of, various types of insurance coverage, insureds should get not just certificates of insurance (which provide only minimal information about the coverage provided), but copies of the actual policies as well. Only the policy will clearly confirm the limits, terms and conditions, insurance agreement exclusions and additional insured status provided. Knowing exactly what coverage is available, and having copies of relevant policies when claims arise, can also make claim handling and resolution much easier. Insureds with policies triggered by an "occurrence" should keep them forever, although they often do not.

2. Understand What Is Available from All Participants

Although most project participants have a vague general understanding that some insurance coverage is available to project participants for certain types of claims, the level of knowledge and understanding of what is available, how it is triggered and its scope, is varied and tends to be low, even among sophisticated construction personnel. While most project participants assume workers compensation coverage is available to cover injured workers, few understand the bodily injury coverage which may be available under a CGL policy. Moreover, only a few very sophisticated members of any project staff will understand that property damage coverage under a CGL policy typically includes both physical damage to tangible property *and* loss of use of undamaged tangible property, let alone the specialized coverages available under some environmental, professional liability or builder's risk policies.

Accordingly, consider training to educate project personnel on the coverage purchased for the project, both at the outset of the project, and throughout construction. Educate senior management to the uses of coverage. Consider preparing a written summary or "cheat sheet" for senior project personnel. And, for larger projects or clients, consider periodic in-house training on how the available insurance works.

C. Non-Solutions

"Don't ask, don't tell" is not a viable strategy here, or really in any of these scenarios. There are two problems, the more important of which is the uninsured risk, but also, parties may treat the failure to timely obtain insurance as a material breach of contract. Ignoring the problem means that a constructive solution never is put in place.

D. Emergency Procedures

What the construction lawyer should do, when a contractor,

owner or designer comes to them (perhaps sheepishly) and explains that it started without some of the mandatory coverage, is to set about establishing insurance *back to the commencement of the Work*.

Assuming that there has been no loss during the gap, most carriers, in most situations, will consider a policy that starts with the beginning of the relevant work. What they typically require is a "no known loss" letter, which acts like an addendum to the application. If it misrepresents conditions known to the insured, the carrier very likely will cancel the policy and treat it as void for fraud. However, the good news is that it is fairly straightforward to state that no loss has occurred, whether this concerns a builder's risk policy or getting an additional insured endorsement. Even a CCIP can be cured in this way, although there is more of an administrative burden in getting all parties enrolled in the coverage. Any experienced carrier should already have been experienced in this happenstance, already.

If a loss has occurred, there is very little chance of obtaining coverage. Carriers almost never insure against known losses or events.

CONCLUSION

Proper contractor licensing remains a problem that can quickly jeopardize an otherwise promising construction project. Many times, the problem is not one of competence, but rather of compliance with regulations not clearly understood or appreciated. While most licensing systems are designed to protect consumers from unscrupulous tradesmen and purported contractors, even sophisticated, highly competent contractors can run afoul of state licensing schemes when they venture into another jurisdiction or discipline. Likewise, problems with lenders, sureties and insurers, as well as rival contractors, can paralyze a project. The job of construction counsel becomes much more challenging if the parties fail to practiced safe project administration from the start.