15

THE TEN METHODS OF GETTING PAID WHEN YOUR CUSTOMER CAN'T OR WON'T PAY

Introduction

When your contracting party becomes insolvent, bankrupt, or refuses to pay, your normal and proper reaction is to start looking for an alternative source of payment. This chapter reviews ten methods by which payment can be obtained from third-party sources.

Claims against payment security are often appropriate even when your contracting party is financially able but slow in paying you. By simply starting the process by which you can exercise your rights under one of the forms of payment security, you exert leverage which often leads to prompt payment. For example, merely giving notice of an intent to file a bond claim or mechanics' lien claim is sufficient to obtain a payment that has been delayed.

Principles of Collections Management in the Construction Industry

Construction company managers often intentionally let their payment security rights expire, by failing to give timely notice, out of fear that the giving of such notice might do damage to customer relationships. There are, however, ways of approaching your customer to let them know that you are exercising your rights that will not offend them.

> **Advise your customer in a friendly way that you have a policy of always keeping your payment security rights in effect until final payment is received.**

Where you are concerned with maintaining a good customer relationship, send a cover letter with legal notices explaining that the customer should not take the matter personally or as a hostile gesture, that you value the relationship, but that company policy requires that you maintain your rights, etc. It helps, if prior to payment problems arising, you have established a personal relationship with the individual within your customer's company who handles payments. By taking this approach you can soften the impact of your actions, and hopefully maintain good customer relations.

As soon as you perceive that a payment problem is arising, attempt to get as much information as possible as to why the problem exists. A personal meeting concerning payment problems is preferable to telephone calls and letters. You will nearly always find out key information at such meetings which will guide you in your decision as to how to handle the matter.

Keep in mind, too, that there is nothing inconsistent with attempting to use more than one payment security device at a time, nor is there anything inconsistent about attempting to negotiate directly with your customer while pursuing a payment security option at the same time.

A Note About Arbitration and Payment Security Devices

Where there is an arbitration clause in your contract or purchase order, use of arbitration as a method of determining how much is owed does not preclude you from exercising your rights with respect to payment security against another source of ultimate payment of that amount. DO NOT WAIT until the conclusion of the arbitration proceeding to start the process of exercising your payment security rights, since by then it will probably be too late.

Even where there is an arbitration clause in your contract, file all notices of liens or claims, and file suit in court if necessary, on a timely basis. You can then ask the court to stay the proceeding pending completion of the arbitration.

Once it is determined, through arbitration, that your customer owes you a specific sum, you can then obtain your money from a third party source through the pending bond or mechanics' lien claim.

METHOD # 1: MECHANICS' LIENS

Nature of a Mechanics' Lien

A mechanics' lien is a legal claim against real property to which the claimant has made improvements. A mechanics' lien claim is not based on contract, but is rather a statutory right that arises out of the supply of labor or materials for the improvements to the property without corresponding payment.

The law gives the holder of a mechanics' lien the right to sell the property in order to obtain monies with which to obtain payment for the work performed. When a holder of a mechanics' lien arranges the sale of property in order to satisfy a mechanics' lien, the proceeds are distributed according to state law priorities, and construction lenders, mortgage holders, holders of tax liens, and others often have priority to such proceeds over mechanics' lien holders.

Since a mechanics' lien claim is based on statute rather than contract, a defense based on a pay-when-paid clause in a subcontract is not available to the Owner.

The extent of a mechanics' lien is limited by the nature of the property interest owned by the person who contracted for the improvements. Thus in those states which permit a lien to be placed on a leasehold interest, the lien is on the improvements only, and not on the building itself.

Scope of Coverage and Nature of Lien Granted

There are widespread variations among the states as to the scope of coverage and the nature of the lien granted. Many states only permit prime contractors, suppliers to prime contractors, and first-tier subcontractors to obtain mechanics' liens.

There are two main types of mechanics' lien laws: those based on the "direct" system, and those based on the "derivative" system.

<u>The Direct System</u>

Under the direct system, the claim is against the property itself, and hence the limit which all mechanics' lien holders can recover is the amount of the proceeds of the judicial sale after claimants prior in right have been paid. Under the direct system, an owner can end up paying twice, in the situation where a payment for work done by lower-tier parties is made to the prime contractor and the monies are not passed on to those parties.

The states which recognize the direct system include Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Indiana, Louisiana, Maryland, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

<u>The Derivative System</u>

Under the alternative type of mechanics' lien system -- the derivative system -- the total amount of liens all mechanics' lien claimants can recover is the amount due from the owner to the prime contractor at the time the claims are made. Under the derivative system, the lien is against the funds yet unpaid under the owner's contract with the prime contractor or construction manager. Thus under the derivative system, the owner is not at risk of paying twice.

The states which recognize the derivative system include Alabama, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Mississippi, Nebraska, New York, North Carolina, North Dakota, Oklahoma, South Carolina, South Dakota, Texas, and Virginia.

Procedures for Enforcing a Lien

There are also wide variations among the states as to the procedures used in establishing and enforcing a lien. These matters can be highly technical, and it is recommended that they be performed by an attorney with significant prior experience in such work.

One of the most complicated areas of the law of mechanics' liens, which is a common problem for residential contractors, is tracking work on specific houses to specific invoices.

In most states it is necessary to obtain a title search in order to obtain a legal description of the property and to determine whether there are any other mechanics' lien claimants.

While state laws in this regard vary widely, obtaining a mechanics' lien is generally a two step process, the first step being the filing of a notice of intent to lien, and the second step being the filing of a lawsuit to enforce the lien. Like payment bond claims, the time within which mechanics' lien claims must be filed is usually tied to the claimant's last day of work.

The last day of work for mechanics' lien purposes is the last day on which materials or labor called for under the claimant's contract were supplied to the job. While punch list work generally counts, warranty work or come-back corrective work which is performed after occupancy generally does not.

A few states require some form of legal notice to be filed prior to performance of any work, in order to maintain mechanics' lien rights.

There is a wide variation among the states as to the priorities of distribution of the proceeds of a foreclosure sale to enforce a mechanics' lien. The general rule is that secured lenders and mortgage holders have priority as long as their interests were filed prior to significant, visible work being performed on the site.

Mechanics' lien holders usually have priority over judgment holders and tax lien claimants whose claims were adjudicated after the construction of the project commenced. Among mechanics' lien holders themselves, laborers usually get paid first, then lower-tier parties, then higher-tier parties, with each class sharing *pro rata* among themselves.

As a practical matter, what this means is that if it actually comes down to selling the property at foreclosure sale, the mechanics' lien holders may see only a portion of their money, or possibly none at all. Actual foreclosure sales, however, in fact rarely occur. The standard practice is for the owner to post a surety bond in lieu of the liens, to avoid sale of the property while payment disputes are resolved.

The Dangers of Mechanics' Lien Waivers

Mechanics' lien rights are often lost as the result of unintentional waivers of such rights. There are three documents in which mechanics' lien waivers can occur:

* Lien waivers may be contained in your subcontract or purchase order.
* Partial lien waivers are normally submitted with progress payment requisitions.
* Final lien waivers are normally required at time of final payment.

When you come across lien waivers in your subcontract or purchase order they should be stricken from such documents. *Partial* waivers submitted with monthly progress payments are standard business practice and are not objectionable, but they should be made applicable only to monies earned up to the end of the period for which the requisition is made, rather than the payment date. Such waivers should also not be applicable to pending claims; and should not become effective until the payment in question is actually received. Similarly, final lien waivers should be amended to exclude pending or known claims.

METHOD # 2: MILLER ACT PAYMENT BONDS

Purpose and Scope of Coverage

Since it is not possible to place a mechanics' lien on federal government property, a federal law known as the Miller Act requires surety bonds to be posted by general contractors on federal construction projects, which provide essentially the same payment protection which mechanics' liens play in private projects. A payment bond requires the insurance company which posts the bond to pay for materials and labor provided to a project where the general contractor fails to make such payments.

If the owner on a project is the Federal government, by law the prime contractors must obtain a payment bond covering labor and materials supplied to the project. Miller Act payment bonds are required on all Federal projects exceeding $100,000. The amount of the bond is a percentage of the contract price.

The fact that a project is *funded* by the Federal government is not enough to invoke the Miller Act payment bond requirement. The owner must be an agency of the Federal government.

Miller Act payment bonds cover the costs of labor and materials (including mark-up) provided to a project by subcontractors, sub-subcontractors, suppliers to the prime contractor, and suppliers to a subcontractor. Third-tier parties (sub-sub-subcontractors and suppliers to second-tier subcontractors) are not covered.

The term "subcontractor" under the Miller Act is defined as a party who takes on the obligation of performing a part of the prime contractor's scope of work. Manufacturers of specially-fabricated materials for use on the particular job in question are deemed subcontractors, rather than suppliers.

Costs of materials used up or consumed in the course of construction -- for example the cost of fuel, tires for earth-moving equipment, etc. are covered. Materials which are delivered to the site for intended use in the project are covered, despite lack of proof of such actual use. Costs of purchasing capital equipment, costs of borrowing money to finance equipment or project cash flow, or insurance premiums are not covered. Additional costs over the contract price which arise out of delays to the project caused by the claimant's upper-tier contractors are covered by Miller Act bonds.

Since payment for labor and materials provided to a general contractor for a federal government construction project is required by law, a Miller Act surety cannot rely on a pay-when-paid clause in the subcontract agreement to deny payment to a subcontractor or supplier.

Interest and Attorneys' Fees

Recovery of interest in Miller Act lawsuits is governed by state law. Attorneys' fees are generally not covered, unless payment of such fees is provided for in the contract between the claimant and its contracting party.

Notice Requirements

Where a project participant has a contract directly with the prime contractor -- such as a first-tier subcontractor or a supplier to the prime contractor -- there is no notice requirement prior to filing a Miller Act suit. For all other covered parties, Miller Act rights are lost if they fail to send a written notice, by registered mail, to the prime contractor in time, so it is actually received within ninety days of the date on which they last supplied labor or materials under their contract.

A Miller Act notice must be from the claimant itself. A letter from a subcontractor on behalf of a supplier, for example, is not adequate.

It is necessary to obtain a return receipt from the post office to document the delivery of the notice. If the party refuses its mail you may need to serve the notice by a process server, so don't wait until the last minute to send the notice out.

For purposes of determining the date of the last work from which to count the ninety day notice requirement, replacement work, corrective work, warranty work, or other types of "comeback" work do not generally start the 90 day time period running again.

Lawsuits to Enforce Miller Act Bonds

Suits to enforce Miller Act payment bonds are brought in the name of the United States. The suit must be filed in the federal court in the jurisdiction in which the contract was to be performed.

The suit cannot be filed earlier than ninety days from the date of the last work, nor any later than one year from the date of the last work.

Defenses

A surety can assert any defenses available to its principal, including offsets for damages alleged to have been caused the principal by the claimant. A pay-when-paid clause in the claimant's subcontract or purchase order, however, is not a valid defense in a Miller Act suit, since liability exists by statute notwithstanding non-payment by the government.

A claimant is barred from suit where the amount sought was available to it in the form of a joint check, where the claimant did not deduct the portion due it from the proceeds of that check.

Pointers on Miller Act Litigation

The bankruptcy of your customer does not prevent you from filing a Miller Act suit against the project payment bond surety. Once a bankruptcy petition has been filed, the automatic stay provision of the Bankruptcy Code prohibits you from taking any action to seek payment from the debtor itself. This does not prevent you, however, from pursuing payment from the payment bond surety. You can still file a Miller Act suit against the payment bond surety as the sole defendant.

If you fear your contracting party on a federal project may file for bankruptcy, attempt to reach an agreement as to the amount that is due to you, even though you are fully aware that party itself has no money to pay you. If your contracting party files for bankruptcy and lists you on its schedule of debts with an undisputed amount, you can use that list as evidence as the basis for your claim against the Miller Act surety.

METHOD # 3: LITTLE MILLER ACT BONDS

Introduction

All state governments protect lower-tier contractors on their construction projects in a similar manner as the federal government, under what are known as Little Miller Acts. Just as construction subcontractors and suppliers should have an automatic association between federal government projects and Miller Act payment bonds, where a state government entity is the project owner, there should be a similar association with Little Miller Act bonds.

While the payment bond statutes of most states track the Miller Act, and rely on Federal case law to interpret the state statute, the statutes of some states differ in scope of coverage and in notice requirements.

Enforcement of Little Miller Act Bonds

In most states, suits in Little Miller Act cases are filed in the claimant's name, not in the name of the state. In most states the same notice requirements apply as used in the federal Miller Act, but be sure to have your attorney check your state's statute on this point.

Implied contracts, where a general contractor assures a second-tier supplier or subcontractor that it will be paid, do not create a contractual relationship of the nature which would avoid the statutory requirement that a second-tier party must give timely notice of its claim to the general contractor.

Where there is a conflict between the notice requirements of the statute and notice requirements set forth in the bond itself, the statute controls. On the other hand, where the wording of a payment bond is broader than that required by statute, the wording of the bond controls, and the expanded coverage is available.

Many cities, counties and other municipal governments have statutes or ordinances which track the state's Little Miller Act, requiring payment bonds on local projects over a stated dollar limit. Most of these statutes and ordinances contain similar notice and time requirements as the state Little Miller Act statutes.

METHOD # 4: PRIVATE PAYMENT BONDS

Introduction

Many private owners require general contractors or construction managers to purchase payment bonds for their projects. A subcontractor or supplier should inquire when negotiating its contract whether a job is bonded, and if it is, request a copy of the bond.

The fact that a construction project participant has mechanics' lien rights in effect does not bar the filing of a claim on the project payment bond. A bond claim is generally more effective than a mechanics' lien claim, because there are numerous defenses to mechanics' lien claims which are not applicable to bond claims. In addition, the notice requirements are often not as stringent on payments bonds as they are for mechanics' liens.

Whether a surety on a private payment bond can rely on a pay-when-paid clause in a subcontract to deny payment to a subcontractor varies from state to state. The better rule is that the obligation of the surety is to pay for materials and labor provided to the job -- regardless of whether the general contractor has been paid. Not all courts follow this rule, however, and for that reason you cannot rely on a payment bond to assure payment where there is a pay-when-paid clause in your subcontract.

Enforcement of Private Payment Bonds

Many of the rules applicable to enforcement of Miller Act and Little Miller Act bonds are often contained in the terms of private payment bonds. Where a private payment bond contains notice requirements and limitations on when suits must be filed, those provisions must be complied with.

It is always a good practice to obtain a copy of the project payment bond well before payment disputes arise. The general contractor or construction manager has an obligation to provide a copy of the bond when requested to do so.

Payments made to subcontractors and suppliers in the normal course of business are not payments "under" a payment bond which would have the effect of reducing the obligation of the surety. Further, the fact that a prime contractor has paid a subcontractor in full is no defense to a claim on a payment bond by sub-subcontractor or other lower-tier party.

A mechanics' lien waiver does not automatically waive payment bond rights, absent specific language to the contrary.

Where a joint venture takes out a payment bond, a contract with a member of the venture constitutes a "direct contract" so as to place the contract within the scope of coverage of the bond.

If your contract on a project is terminated, you may proceed against the payment bond surety on a theory of quantum meruit -- that is, the value of the labor and materials supplied to the project.

Nature of Payment Bonds, and Comparison to Performance Bonds

The purpose of a payment bond is to assure that parties who supply labor and materials to a project are paid (that is, the bond is obtained by an upper-tier party, to protect lower-tier parties from default on payment). The purpose of a performance bond is to assure that a lower-tier party will properly and timely complete its work (that is, the bond is obtained by a lower-tier party, to protect upper-tier parties from default on performance). Where a bonded participant in a construction project is unable to perform, its upstream contracting party can rely on that party's performance bond surety to take over the contract, and to engage another party for the completion of the contract, and to cover the damages incurred by the upper-tier party as the result of the default.

The scope of a performance bond surety's obligations is established by the particular wording of the bond. Some broadly-worded performance bonds take on obligations by the surety to lower-tier parties which are similar in nature to those covered by payment bonds, and thus performance bonds should be explored as alternative sources of payment where no payment bond is in effect.

METHOD # 5: COMMON LAW AND STATUTORY TRUST FUND PROVISIONS

Introduction: The Nature of "Bankruptcy Bypass"

Statutory trust fund provisions and private trust fund agreements are designed to prevent funds payable by an owner to a general contractor from becoming part of the "estate" of the general contractor, in the event it files for bankruptcy.

An example of the problem that trust fund provisions address is as follows: Assume that monies are due from an owner to a prime contractor, for work performed and materials delivered primarily by subcontractors and suppliers. The prime contractor files for bankruptcy protection, and the bankrupt firm claims the money as an asset of its bankruptcy estate. If this contention is upheld, it would leave the subs and suppliers as general unsecured creditors -- with little hope of obtaining much more than a fraction, if any, of the amount due, with payment made years later. If however, the funds owed by the owner to the general contractor are deemed to be held in trust by the general contractor for the benefit of lower-tier parties, then the money can properly and lawfully be paid to those who in reality earned the money -- the subs and suppliers.

The same principles apply, of course, where a subcontractor files for bankruptcy and a sub-subcontractor or supplier to the subcontractor seeks payment from the prime contractor.

The Nature of a Bankruptcy Preference

The same problem can also exist in reverse, where a payment is made to a lower-tier contractor, and then the upper-tier party files for bankruptcy within 90 days of the date of the payment. In such cases, the bankruptcy trustee can claim that the payment was not made in the ordinary course of business, constitutes an unlawful preference, and hence must be paid back. Where, however, the funds in question are found to have been trust funds, there is no obligation to pay them back to the upper-tier party.

In certain states -- North Carolina, New Jersey, Arkansas, Mississippi, Maryland and Virginia, there are state statutes which recognize the monies due the general contractor as trust funds under the circumstances specified. Certain other states -- Alaska, California, and Rhode Island -- have "stop-lending" statutes, under which an unpaid subcontractor or supplier can impose obligations of payment on construction lenders.

In states which do not have such laws, contracting parties can establish private trust fund arrangements by contract -- simply by providing in a subcontract that payments received by the general contractor from the owner for work performed by the subcontractor shall be deemed held in trust for the subcontractor.

METHOD # 6: JOINT CHECK AGREEMENTS

In circumstances in which you are unwilling to rely on the credit of your immediate customer, a method of assuring payment is to enter into a three-way joint check agreement, in which your customer's contracting party agrees to pay your portion of your customer's payments in the form of a two-party check made out to your customer and yourself.

A Joint Check Agreement can be a useful method of obtaining payment security, even where other methods are also available.

A Joint Check Agreement should be signed by three parties -- your customer, your customer's upstream party, and yourself. The Agreement should obligate your contracting party to designate in its payment requisitions what portion of the requisition should be paid to you, and should obligate the upstream party to pay your portion of each requisition in the form of a separate joint payee check to your customer and to you.

The likelihood that the courts will regard the joint check as belonging to you increases the more all parties treat the money as yours. For example, it is best if the check is mailed to you, and you hand carry it to your customer for endorsement. In the alternative, the issuer of the check can arrange for your customer to go to its office to sign the check before it is mailed to you.

Under joint check arrangements, the upper-tier party is only obligated, of course, to make payments which are properly requisitioned by the intermediate party. If due to backcharges or offsets no monies are due, then the upper-tier party has no obligation to make any payment. A Joint Check Agreement does not create an independent obligation on the part of the upper-tier party to pay the lower-tier party. Its obligations are governed by the contract between the other two parties.

See Appendix 5 for a sample Joint Check/Trust Fund Agreement.

METHOD # 7: NOVATIONS

There may come a time in the performance of your work on a project where it would be advantageous to you to withdraw from the contractual relationship with your contracting party and form a new contract with the contractor at the next tier up. This is possible, if you can obtain the cooperation of the parties, by means of what is known as a novation.

A novation involves the cancellation of one contract, and the formation of a new contract, in which one of the contracting parties agrees to perform its obligations to a third party. A novation agreement requires three parties.

For example, say a subcontractor is having difficulty on a job, and is not paying its sub-subcontractor on a timely basis. The sub-sub fears that the sub will file for bankruptcy, or perhaps just fold and go out of business. For a worst case scenario, further assume that there is no payment bond, the state in which the project is located gives no mechanics' lien rights to sub-subcontractors, and at the start of the job the sub-sub, having not read this manual, didn't realize that it might have been able to obtain a joint check arrangement with the prime contractor. The sub-sub can see disaster looming. His solution: a novation -- withdrawing from his contract with the first-tier subcontractor and substituting a new contract with the prime contractor.

In order to accomplish a novation, the sub-sub first goes to the sub and persuades him to let him out of his contract, conditioned on the prime accepting a novation. He then goes to the prime and says, look, I am getting ready to walk off this job because your sub isn't paying me, leaving you with a major sized problem. But, if you would like to hire me directly to perform my work, I have been advised that your sub will release me.

The parties then enter a three-way agreement, in which the subcontractor agrees to release the sub-subcontractor from its uncompleted contractual obligations, and under which the prime contractor enters into a new agreement directly with the sub-sub for the completion of the balance of its work. The prime agrees to pay sub-sub both the amounts that are past due from former sub plus the balance remaining for the uncompleted work.

There are a number of circumstances in which novation agreements are to the benefit of all three parties, and this device should be kept in mind for use in appropriate circumstances.

METHOD # 8: ACCOUNTS RECEIVABLE ASSIGNMENTS

There is one more payment security device which may be used when you are desperate and nothing else is available: the accounts receivable assignment, where your customer assigns his accounts to you for collection in payment of his debt to you.

Accounts receivable assignments can work one of two ways: accounts can be assigned to you as additional security for payment. This method does not involve a release of the debt to you, but only provides you with a source of money, as a form of collateral, in exchange for a stated period of time for forbearance from suit. The second method involves giving up a claim against your creditor in exchange for an assignment of one or more of his accounts receivable.

It is also possible, of course, to do a combination of these two, or even more unusual arrangements, where a substantial number of accounts are assigned, with an agreement of cooperation and a schedule for sharing of proceeds. Creativity is required in difficult situations, in order to find a way to get paid in full.

The more a firm owes you the more likely it is that you can do better by cooperating with it instead of suing it. You also get the advantage of a jump on the other creditors, who will likely take the much slower and more cumbersome method of suing on their debts.

Solid claims often go uncollected because the claimant lacks the funds to hire counsel to pursue the claim, or lacks the expertise to put the claim together. If you see one of your contracting parties going down the tubes, and you have no chance of collecting from any of the third parties on the horizon, accepting an assignment of a claim is better than nothing.

METHOD # 9: THIRD-PARTY BENEFICIARY OF AN UPSTREAM CONTRACT

An alternative theory to support direct payment to you by your customer's customer can sometimes be found in clauses in the contract between your customer and its upstream contracting party. Typical of the types of clauses I am referring to would be a provision that requires the prime contractor to submit proof to the owner that the prime has paid all of its subcontractors and suppliers on a current basis as a condition precedent to entitlement to its monthly progress payments, and with the owner reserving the right to make direct payments to subcontractors and suppliers. This is an example of such a clause in the prime contract.

> Contractor shall promptly make payments to all persons supplying labor, materials and supplies to the project. Owner will make any payments which Contractor fails to make, the amounts thereof to be deducted from any monies earned or due the Contractor.

By contacting your customer's contracting party and advising it of nonpayment, you may be able to persuade it to pay you directly. In a pinch, your contracting party's contract with its upstream party should be carefully examined for this type of clause.

METHOD # 10: ESTABLISHING OFFICER LIABILITY FOR YOUR CUSTOMER'S CORPORATE DEBTS

As a last ditch effort, you may also want to look at the possibility that you can "pierce the corporate veil" and go after the owners of your corporate customer. Some states, notably Maryland, have statutes which establish personal liability on the part of corporate officers who collect monies due to subcontractors and fail to make payments to the subs. Failure of your customer to maintain proper corporate status may also provide an opportunity to pursue individual liability.

This method of seeking payment is indeed a long shot. Where the party you are dealing with is properly incorporated and its operations conform to the statutory requirements, you may collect debts owed to you from the corporation only. There is a doctrine in law that, under very limited circumstances, permits the corporate form of an entity to be ignored, and permits collection of debts against its owners. The burden of proof in such cases is, however, very high. You must show that the owner used the corporation as a mere shield for the perpetration of a fraud, or treated the corporate property as his own, and that he himself disregarded the corporate form.

Another avenue of approach where a corporation is abandoned and its assets transferred to another entity is to attempt to follow the assets. Where you can prove that assets were transferred to a new entity without full and fair consideration, you can attack the transfer as being a fraudulent conveyance. If you are successful, the funds which were improperly transferred must be returned to the original entity, and can then be used to satisfy your debt.

Summary of Chapter

Payment security is designed to provide an alternative source of payment when your contracting party cannot or will not pay you. There is nothing improper about pursuing a form of payment security at the same time you are attempting to get payment from your own customer, nor is there anything improper about pursuing more than one alternative source of payment at the same time.

The ten sources of payment security are as follows:

1. Mechanics' Liens
2. Trust Fund Statutes or Trust Fund Agreements
3. Miller Act Payment Bonds (federal projects)
4. Little Miller Act Payment Bonds (state projects)
5. Private Payment Bonds
6. Joint Check Agreements
7. Novations
8. Accounts Receivable Assignments
9. Upstream contractors under a third-party beneficiary theory
10. Corporate officer liability

16

CREATING AN EFFECTIVE RISK MANAGEMENT PROGRAM

PROPERTY INSURANCE

Introduction: The Important Distinction Between First Party and Third Party Insurance

There is an important distinction between first party and third party insurance policies. First party insurance covers the insured's own property. On a construction project, this includes your equipment, your trucks, your work in place, etc. Third party insurance, in contrast, covers your legal liability to third parties, arising out of your negligence or wrongful acts. In essence, first party insurance covers losses suffered directly by you; third party insurance protects you when someone else sues you to recover their losses.

Automobile insurance combines both types of insurance into a single policy -- that is, insurance for damage to your car, and insurance to protect you from liability to others.

On a construction project, first party and third party insurance are purchased through separate policies:

* First party insurance on construction equipment is obtained through an equipment policy.

* First party insurance on items which are being installed on a project may be obtained in the form of an Installers and Riggers Floater Policy.

* First party insurance on damage to the project itself (including your own work) may be obtained through a Builder's Risk Policy.

* Third party liability -- for example, liability to an injured worker other than your own employees -- is covered by a Commercial General Liability Policy.

The Nature of Builder's Risk Insurance

Builder's Risk insurance is a type of first party insurance which covers damage to a building under construction. There are two types of Builder's Risk policies: "all risks" policies, which cover all risks other than those specifically excluded, and "named perils" policies, which cover the hazards specified in the policy.

The foundation for any Builder's Risk policy is the standard fire policy, to which is added either the Builder's Risk Special Extended Coverage Endorsement or the Standard Extended Coverage Endorsement.

There are two ways in which Builder's Risk coverage may be specified and premiums calculated. The first method is based on the Completed Value Form, and involves level premiums based on 50% of the normal Builder's Risk rate, applied throughout the job. The second method is based on actual value, and involves increasing premiums, calculated against monthly Reporting Forms, which specify the value added to the building during the previous month.

Contractors can purchase Builder's Risk policies on a project-by-project basis, or by blanket policies covering all projects. Where owners purchase the Builder's Risk policies, contractors can purchase "wrap-around" policies which provide supplemental coverage for any gaps in the insurance purchased by the owner.

It is important for each participant on a construction project to become a named insured on the Builder's Risk policy. Sometimes owners or general contractors try to save money on their insurance premiums by deleting coverage under the Builder's Risk policy for lower-tier parties. Demand that you be included in such coverage.

Scope of Builder's Risk Coverage

Builder's Risk policies generally cover damage to the work in place, stored materials on site, and temporary structures on the site, such as false work, forms, and office trailers. If, for example, a fire is accidentally started by a subcontractor's defective equipment, damage to the structure under construction would be covered by a Builder's Risk policy.

Deficiencies in design, specifications, workmanship or materials are not covered. This exclusion has been interpreted to be limited to the specific part of the work that fails, and not to other work damaged as a result of such failure.

Many standard policies exclude three forms of water damage: water backup in sewers or drains; water below the ground exerting pressure on the structure or leaking or seeping in; and flood damage.

Builder's Risk policies do not normally cover consequential damages, such as lost rent in the event of delays in placing a building in service.

Builder's Risk coverage usually goes into effect on the first day of on-site construction, and ends on the occurrence of specified event -- usually occupation of the structure.

LIABILITY INSURANCE

The Nature of Liability Insurance

Liability insurance is third party insurance, and is designed to protect you from lawsuits brought by third parties against you. The purpose of liability insurance is to cover unexpected, unintentional, and accidental personal injury and property damage.

The basic business liability policy was prepared by the Insurance Services Office (ISO), and is applicable to all businesses. The policy is known as the Commercial General Liability (CGL) policy. The policy currently being used was issued by ISO in 1986, which replaced the 1973 policy. Insurance reference books and many court decisions based on the 1973 policy are now obsolete.

Since the CGL policy is written in extremely broad language, applicable to all types of businesses, it frequently occurs that there are situations which arise where it is unclear whether there is coverage available for a particular loss. This occurs far more often that one would normally expect. It is very important to use an insurance agent who is familiar with the construction industry, and who can assist you in the event it is necessary to file a claim.

In order to be entitled to any coverage you must promptly notify the insurance company when any claims are brought against you.

Where the insurance company is unsure as to the existence of coverage, a defense of a claim may be undertaken under what is known as a "reservation of rights" -- that is, the insurer agrees to defend but does not agree in advance, pending further review of the matter, to pay the claim. Since there are many ambiguities in CGL policies, you should not hesitate under appropriate circumstances to challenge an insurance company's denial of coverage.

The Two Components of a Liability Policy

There are two components to a liability policy: the duty to defend, and the duty to indemnify (pay claims).

The most important thing you must know about liability insurance is that the duty to defend is much broader than the duty to indemnify. Since the duty to defend is broader than the duty to indemnify, there are circumstances where your insurance company must provide you with a lawyer but may not be obligated to pay the claim against you.

If there is any basis at all under which you may have coverage, there is a duty to defend. The attorney provided to you by your insurance company owes his or her sole allegiance to you, and only a secondary duty to the insurance company. The attorney provided to you by the carrier should not become involved in any coverage disputes. Even where your defense is provided under a reservation of rights, you are entitled to a first class defense.

The Rules for Interpreting Policies Favor the Insured

The second thing you must know about liability insurance is that where there are ambiguities in a policy, the policy is to be interpreted against the insurance company and in favor of coverage.

You do not need to prove that your interpretation is the only reasonable one; all that you need to show is that your interpretation is reasonable. In some states, all that you need to show is a reasonable expectation of coverage.

For many construction accidents, different policies cover different types of damages, and even well-recognized insurance experts often differ as to whether a particular item of damage is covered. Do not accept your carrier's interpretation of its policy as gospel; it may be wrong.

Availability of Coverage for Construction Backcharges

The third thing you must know about liability insurance is that if you have monies withheld from your pay requisitions or retainage as the result of an accident you may be entitled to reimbursement from your CGL insurance carrier. Indeed, under the duty to defend, your carrier may be obligated to sue your contracting party on your behalf to challenge the validity of backcharges related to accidents.

Many insurance professionals are unaware of standard practices in the construction industry, and will not be familiar with the practice of backcharging lower-tier parties. Where you are seeking coverage for backcharge claims, you should have your attorney involved in the claims process.

Avoiding Gaps in Coverage When Switching Policies

The fourth thing you must know is how to avoid gaps in coverage.

An "occurrence" policy covers losses which occur during the policy period, regardless of when the claim itself is filed. In contrast, a "claims made" policy covers claims filed against you during the policy period. A "claims made" policy does not cover claims filed after the end of the policy period, even if the event on which the claim is based occurred while the policy was in effect.

Beware switching from a claims made policy to an occurrence policy, since an occurrence policy would not cover a claim which arises in a prior policy period but not filed until the present policy period. A rider to an occurrence policy can be purchased to cover obligations which occurred prior to the policy period.

Administrative Aspects of Liability Insurance

In the event you are sued, you must immediately call your carrier to determine the name and address of the person to whom you should send the suit papers. Be sure to write on the face of the suit papers the time and date you were served, and the name and title of the person served.

Send the suit papers by overnight delivery service to the CGL carrier. Then have your own attorney contact the plaintiff and arrange an extension of time for filing an answer to the suit, to give the insurance company additional time to make its coverage decision and to hire an attorney for you.

You have a duty under your policy to cooperate with your insurance company and the attorney hired to defend you. Your duty to cooperate includes providing documents, showing up for depositions, showing up in court, providing information and signing court documents.

Do not attempt to settle a matter directly with the other party -- you may void your insurance coverage by doing so.

UMBRELLA COVERAGE

Umbrella coverage has several functions. It increases your limits of coverage, adds coverage for certain types of losses your CGL policy excludes, and extends the duty to defend once your policy limits are exhausted. The policy periods for Umbrella coverage should match that of your underlying insurance.

WORKERS' COMPENSATION INSURANCE

Nature and Scope of Workers'' Compensation Coverage

Every state has workers' compensation laws which require an employer to pay certain benefits to an employee who becomes injured or sick in the course of his or her employment. Workers' Compensation benefits are payable regardless of issues of negligence or fault.

There are two coverages available. The first is the workers' compensation coverage itself, which covers both bodily injury (including death) and occupational diseases. The second is employer's liability, which covers employees who for one reason or another are not covered by workers' comp.

Employer's liability covers claims by persons who are excluded from workers' compensation coverage by law; in the few states where coverage is optional employees who have elected not to come under workers' comp; claims for diseases excluded from coverage; claims by persons who could not be covered because they were hired illegally; suits by spouses for loss of consortium which are not covered by workers'' comp. -- and what are known as "third party over" claims, where an employee sues another party and that party in turn sues you for contribution for having caused or contributed to the accident.

Excluded under employer's liability is contractual liability to your upstream contracting party for indemnification for his negligence; claims for unlawful discrimination or wrongful discharge; and claims by illegal employees where management knew the employee was hired in violation of the law.

Also excluded from workers' compensation coverage is liability to employees for unlawful discrimination or wrongful discharge. Coverage may also be voided where an employer knowingly hires an employee in violation of the law.

The Carrier's Lien in Third Party Actions

Although an employer, and in many states upper-tier parties deemed "statutory" employers, are immune from suit by injured employees (workers' compensation being their sole remedy), other subcontractors and lower-tier parties are often exposed to third party suits for negligence. Where injured employees recover from third parties, there is a statutory lien on the proceeds of such litigation, in favor of the workers' compensation carrier, for the amounts paid out to the injured employee.

Workers' compensation rates are generally determined on the basis of ratings of employers performed by the National Council on Compensation Insurance. The higher your loss experience the higher the rating -- and thus the higher the premiums charged. It is in the employer's interest to assist an employee in a third party action, in that the company's workers" comp rating will be reduced by a recovery of the amounts paid out against the third party.

Chapter Summary

It is important, in developing an effective risk management program, for the management of construction contractors to understand the role which the various types of insurance policies play in their overall insurance program.

First party insurance covers damage to one's own property, or to work in progress. Insurance for one's trucks and equipment is handled by first party insurance policies. Damage to the work itself is usually provided under a Builder's Risk policy.

Third party insurance protects against lawsuits by third parties against you, for the negligent or wrongful acts of your employees which cause personal injury or property damage. Third party insurance is provided under a Commercial General Liability (CGL) policy.

Umbrella coverage adds an additional layer of coverage, above your base insurance policies.

On-the-job injuries and diseases are covered by workers' compensation insurance. Your employees' exclusive remedy to on-the-job injury is a workers' comp claim, and under the workers' comp statutes you are immune from suit.

In more cases than generally recognized, it is unclear whether there is coverage available under a particular policy. The law favors a finding of coverage where a policy is ambiguous. In any event, the obligation of an insurance carrier to provide a defense to a lawsuit against you is broader than the obligation to pay the claim, and you should always send any lawsuits against you to your carrier for defense.

Both your insurance agent and your lawyer can be very helpful in assisting you in making a determination as to how to proceed where claims are brought against you.