DELAYED Payment

ON CONTRACT CLAIMS: Liquidity & the Domino Effect on CREDIT Relationships

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SOME CONTRACTORS CAN AFFORD TO FINANCE MULTIPLE PROJECTS AT A TIME AND WEATHER THE IMPACTS OF PAYMENT DELAYS DURING CLAIMS RESOLUTION. However, for those contractors that do not have the same margin for error, all it takes is one problem project to set into motion a series of unfortunate events that ultimately leads to financial distress.

THIS ARTICLE DISCUSSES COMMON CONTRACT CLAUSES FOR CHANGES AND DELAYS THAT OFTEN LEAD TO CASH FLOW IMPACTS. It also examines the practical implications of delayed payment due on work performed outside the normal monthly requisition process and the impact on banking and surety relationships. And it offers strategies for managing negotiations with credit providers when a contractor is in financial distress based on the relative legal rights between a bank and surety.

Traps for the Unwary: Changes & Delays

While contractors assume that there will be changes and potential delays during the course of any construction project, these possible changes can vary based on the complexity of the project, whether it's new construction or rehabilitation of existing work, the project's coordination needs, etc.

Since there are few ways to effectively mitigate against this uncertainty, and with contractors reluctant to build too many contingencies into their bids to account for such risk, the next best option is for contractors to diligently comply with the contract terms to preserve the right to be paid. Two of the most common "surprises" are *changed or extra work* and *delays and disruption* to the progress of work. The impact of claims made under these clauses are a frequent source of cash flow problems.

Changes Clause

When a contractor encounters changes on a construction project, the first step is to identify whether additional compensation is available for the extra work associated with the change or if it is covered by the scope of work under the original base contract.

An owner will have the right to unilaterally identify additions and changes that will increase the scope of a contractor's work in exchange for additional compensation according to Article 7 and §15.1.3.1 of American Institute of Architects (AIA) Document A201™ – 2017. However, most contracts place the onus on the contractor to notify the owner within a short timeframe as to the existence of the changed condition that the contractor believes to be out of its base contract scope and request compensation for such work.

The relevant contract may also require the contractor to maintain specific time and materials and other cost records in connection with the performance of such changed/extra work as noted in §7.3.4 of AIA Document A201™ – 2017. Both the notice and recordkeeping requirements are strictly construed, and a failure to comply can be fatal to a contractor's ability to recover its costs.[1]

At best, a change order is negotiated, a fair price is agreed upon between the contractor and owner, and the change order is approved *before* the contractor performs any extra work so that the contractor can perform and bill for the additional work in the normal course of contract administration.

At worst, a contractor performs the extra work *before* it has been formally approved as an amendment to the contract and risks being denied a request for compensation for such work. If the contractor does not pause to make sure that it is complying with the contractual notice and recordkeeping requirements for extra or changed work, then it risks waiving its right to recover the cost of that work.

However, the best-case scenario is less common. Even where the contractor is fairly compensated for the cost of the extra work, there is frequently a delay in approval and payment such that the contractor winds up financing the cost of the work for some period of time. If the request for a change is denied *after* the work has been performed and the contractor has financed the work with its own funds, then the contractor is left with the claims procedures within the contract to dispute the decision to deny compensation.

This often involves multiple levels of administrative review and can ultimately result in the commencement of a legal proceeding to recover the value of the work performed. While changes on a construction project can manifest in a variety of ways, the common thread is that extra contractual changes often lead to financial impacts to a contractor.

Delay Claims

When a contractor encounters conditions causing delay on a project, it is also required to provide notice of the condition causing delay and potential costs stemming from such delay within a short period of time, with recurring updates regarding ongoing costs as presented in §15.1.3.1 and §15.1.6.1 of AIA Document A201™ – 2017. Failure to do so will bar a contractor's right to recovery absent a favorable court ruling. However, even strict compliance will not expedite recovery for delay costs as substantial project completion is often required to quantify the full impact from, and seek compensation for, delay claims.

As a result, the contractor is forced to finance its time-related damages throughout the course of the project. For a contractor with subcontractors and suppliers that are unwilling or unable to do the same, the financial impacts are exacerbated; contractors may seek to close out with their subcontractors and suppliers to maintain those relationships and can be left to pursue the recovery of delay costs from the owner.

Moreover, many contracts have *no damages for delay* exculpatory clauses, which either provide for a blanket prohibition on delay damages or limit the recovery to specifically enumerated causes of delay and cost categories.

While there are common legal exceptions to blanket prohibitions on delay damages in many states, these hurdles typically require a contractor to incur additional costs for consultants and lawyers to prepare a delay claim for the owner before they can be compensated for their time-related damages. Whether resolved through litigation, alternative dispute resolution, or on an informal basis, the contractor will likely be required to expend additional time and resources to prove its entitlement, quantify its claims, and overcome the owner's contractual defenses to payment.

Given the strict contractual requirements, contractors must be diligent in providing timely notice and monitoring their costs. Best practices at project inception include having in-house or outside counsel review the contract and prepare a "cheat sheet" for the field personnel that identifies the:

- events requiring notice under the contract,
- time for providing such notice, and
- required contents of the notice, including whether there is a requirement to maintain specific types of cost records.

Impact of Delayed Payment on Credit Relationships

When work is performed outside of the normal monthly requisition process, there will be inevitable payment delays — even where a contractor diligently complies with all contractual notice and recordkeeping requirements. Depending on the size of the construction operations and the magnitude of the delayed payments, the contractor may experience liquidity constraints that impact credit relationships with its key credit providers, such as the bank and surety.

Banking Relationship

Many contractors use a business line of credit to provide access to working capital and additional liquidity. When a contractor has significant uncollected contract receivables, it will experience cash flow constraints that result in a need for increased usage of a bank line of credit and potential covenant defaults. When a contractor is forced to use its line of credit to finance operations on an unprofitable project or one with substantial delayed payments, it limits the contractor's ability to seek new work.[2]

Depending on the structure of the loan facility, the volume of unpaid receivables can result in a contractor's inability to satisfy the borrowing base formula, which is used to determine the availability of future advances. The borrower may also be unable to satisfy the debt service coverage or other debt-to-income ratios in its loan documents when it has not collected its progress billings and/or monetized its claims.

Moreover, if a contractor's financial reporting reflects decreasing gross margins on a project, a bank will typically view this as a sign of poor project management and more closely monitor the progress of ongoing projects and the volume of work in the pipeline.[3] Any of these events can trigger inquiries from the bank about the financial condition of the company and require the contractor to formulate a plan for correcting the liquidity crisis.

Surety Relationship

In addition to access to working capital and liquidity, the availability of bonding capacity through a surety is the lifeblood of many construction companies. When a contractor has been forced to incur costs for which it has not been timely compensated, it may face difficulty in funding project completion and/or keeping up with payments due to subcontractors, suppliers, and other vendors performing work on a project. This can result in liens and bond claims filed by downstream subcontractors and suppliers, as well as a need for the surety to make payments under its bonds or fund completion costs.

Typically, once a surety is forced to intervene on a project, it will retain its own consultants to monitor the progress of work and implement financial controls. Not only will the surety monitor the problem project, but it will also review the financial status of all open bonded projects, particularly when a contractor is requesting the issuance of additional bonds.

Accordingly, cash flow concerns on one project will impact the surety's willingness to extend additional surety credit, thereby limiting a contractor's ability to bid for new work. Similarly, delays in closing out open projects due to open claims will also negatively impact the ability to obtain additional surety credit.

As these examples illustrate, contractors that do not have sufficient liquidity to withstand the delayed and reduced payments that typically accompany claims for extra work and delays can find themselves in financial distress simply based on the timing of payments. Complying with contractual notice and recordkeeping requirements is critical to mitigating the risk of payment delays and demonstrating to key financial stakeholders that the necessary steps are being taken to monetize project receivables.

Nonetheless, a contractor should be prepared to address the concerns of its bank and surety when faced with cash flow problems and resulting damage to its credit profile.

Managing the Crisis

When a contractor is in good financial health, the bank and surety can peacefully coexist. However, when there are indications of potential financial distress, a contractor must understand the different legal rights and priorities under the bank's loan documents and the surety's indemnity agreements, as well as each stakeholder's rights existing at law and in equity.

Often, accounts receivable on bonded construction projects are part of a bank's blanket "all assets" lien but are also assigned to a surety under an indemnity agreement, subject to the surety's common law rights of equitable subrogation and/or treated as trust funds under relevant state law. For contractors that own equipment or other hard assets used in connection with construction operations, the same competing priorities often exist. Therefore, both the bank and surety make credit decisions based on the assumption that each has first priority rights in the contractor's assets in the event of default. When there is a lack of communication among a contractor's key stakeholders, these conflicting views can lead to competing efforts to enforce remedies by the bank and surety against a contractor's collateral.

Competing Rights to a Contractor's Collateral: Avoiding the Race to Enforcement

If a contractor relies on a bank for a revolving line of credit to help manage liquidity and finance operations, then it will be bound by the various covenants and reporting obligations previously described as well as prohibitions on paying other debt without lender consent.[4] Failure to comply with any or all of these requirements can result in a default under the line of credit with broad remedies, including:

- freezing access to additional credit,
- accelerating the entire unpaid balance,
- drawing down cash in any deposit accounts to repay the amounts due, and
- enforcing rights against the collateral securing the loan.

However, when a surety with competing rights in the same collateral is involved, these remedies can lead to lender liability if not properly exercised.[5]

Typically, the same events on a project that trigger a contractor's inability to comply with its loan covenants will also lead to some form of surety intervention. This is due to a build-up of unpaid project payables, the filing of lien or bond claims, or the need for a surety to finance project completion.

In these scenarios, the surety's indemnity agreement will give it broad rights to ensure that the contractor is using cash receipts solely to repay direct project expenses — an outcome that is at odds with a bank demanding repayment of its secured indebtedness. This includes issuing letters of direction, making collateral demands, implementing funds control, or requiring the use of joint checks or other similar tools.

The surety may also be entitled to cross-collateralization of bonded receivables and control over inventory and equipment used on bonded projects. If the surety has taken the necessary steps to perfect its interest in the rights assigned under the indemnity agreement, then it may also have the enforcement rights of a secured creditor under the Uniform Commercial Code (UCC).

In addition to the rights granted under the indemnity agreement, the surety will have common law rights of equitable subrogation to the extent of any direct out-of-pocket project losses that it incurred in paying subcontractors and suppliers. Moreover, the surety is generally free to cut off surety credit without legal recourse by cancelling bonds, limiting bonding capacity, or discontinuing bonding capacity.

Intercreditor Agreement: A Tool to Obtain Mutual Cooperation

As these remedies can lead to conflicts between the bank and surety, it is advisable to align the parties' interests through an *intercreditor agreement*, particularly if either the bank or surety is considering injecting additional funds to help manage the cash crisis. While neither credit provider wants to subordinate its rights in collateral and each will be driven by their individual interests, a practical-minded counterparty will often realize that they may be able to significantly mitigate potential loss through mutual cooperation, which can take many forms, including an intercreditor agreement.

A successfully deployed intercreditor agreement manages the operations of a contractor in financial distress while avoiding the race to enforce rights against collateral. These agreements establish the rights and obligations of multiple secured creditors to each other, typically addressing the otherwise disputed areas of priorities and remedies with respect to a contractor's assets that have been pledged to one or both stakeholders as collateral.[6]

These agreements are often beneficial in bank/surety negotiations; they remove the uncertainty associated with court determinations of the surety's rights of equitable subrogation regarding a bank's first priority blanket lien and other competing rights under a surety's indemnity agreement, a bank's loan documents, and at common law and in equity.

Rather, the intercreditor agreement is recognized under the UCC and state law, which enables parties to contractually subordinate and arrange their relative rights where each party holds a lien securing a different debt obligation of the same borrower.[7]

Accordingly, given that priority disputes can have disparate outcomes, depending on whether they are considered under the UCC or common law doctrines such as equitable subrogation, stakeholders are often well-served to contract for certainty in the event of a contractor default.[8]

While most contractors are not eager to approach their credit providers to inform them of potential financial distress, the bank and surety's limited ability to realize on their collateral if the contractor simply shuts its doors and stops work will provide a strong incentive for the bank and surety to negotiate toward a consensual arrangement.

Where the bank's collateral includes the receivables of bonded contracts that are subject to the surety's competing rights, the fear that the bank's first priority lien will be primed by the impact of either trust fund laws or equitable subrogation rights will often induce the bank to negotiate a sharing arrangement.

As to the surety (which often does not record UCC-1 liens to perfect the rights assigned under an indemnity agreement), the risk of litigating over entitlement and priority based on the assignment clauses in an indemnity agreement and equitable subrogation rights will create an incentive to reach a consensual arrangement. Additionally, the distraction, time, and expense of litigation over rights in and to a contractor's collateral negatively impacts its ability to successfully complete projects, thus leading to greater losses for all parties.

For these reasons, a contractor may want to broker intercreditor negotiations among the bank and surety. In one-on-one negotiations between the contractor and either the bank or surety, the contractor will have little leverage.

However, introducing another stakeholder with competing rights will shift the negotiating dynamics by forcing each credit provider to confront its own risk; the protections embedded in the underlying documents may not be enough to prevent significant losses if the other key stakeholder begins to exercise its remedies in an uncoordinated fashion.

To mitigate that risk, each participant will be more likely to make concessions. Where a contractor has a combination of bonded and nonbonded work, through an intercreditor agreement, the parties can agree that the bank will have first priority rights in the proceeds of nonbonded contracts and the surety will have first priority rights in the proceeds of bonded contracts. The surety will likely also seek to secure a first priority right in inventory used on bonded projects, however, assets not specifically tied to bonded contracts can become part of the bank's first priority collateral. Where all of the contractor's projects are bonded, this negotiation becomes more difficult as the surety is less willing to make concessions on assets tied to bonded work.

The outcome of the negotiation will likely turn on the extent to which the bank is willing to continue serving as a funding source. If the bank is willing to finance the contractor through project completion on bonded work, thereby mitigating the surety's exposure, then the surety is more likely to compromise on other issues. Ultimately, understanding each party's rights and how a collaborative approach can benefit all stakeholders is the key to a successful intercreditor negotiation.

Although the results of an intercreditor negotiation may lead to better long-term outcomes, a contractor may come out of such a negotiation with less control and greater restrictions on access to funds. For this reason, it is critical to assess the situation and the particular relationships to evaluate when the benefits of such a negotiation outweigh the impact of the restrictions that will be put into place.

Conclusion

Contract compliance and project performance are critical to navigating the uncertainty and delays that often accompany construction work but, ultimately, a contractor's relationships with its key stakeholders will carry the day. Credibility goes a long way in maintaining the trust of the bank and surety, and their ongoing support is required to withstand financial distress.

The key to establishing that credibility is to build a strong track record of successful project management. One of the primary cornerstones of successful project management is contract compliance and preserving payment rights through informed and effective communication regarding contractual notice, and adhering to recordkeeping requirements is the first step toward building a strong record. ■

Endnotes

1. *A.H.A. General Construction, Inc. v. New York City Housing Authority.* 241 A.D.2d 428 (N.Y. App. Div. 1997); *F. Garofalo Electric Co., Inc. v. New York University.* 300 A.D.2d 186 (N.Y. App. Div. 2002).

2. "All Work and No Pay: Change Orders Delayed for Small Construction Contractors." Small Business Committee Document Number 115-022. 115th Congress. U.S. Government Publishing Office. May 25, 2017. *www.govinfo.gov/content/pkg/CHRG-115hhrg25498/html/CHRG-115hhrg25498.htm.*

3. Strischek, Dev. "A Written Policy for Lending to Contractors." *The Journal of Lending & Credit Risk Management.* June 1999. *https://cms.rmau.org/uploadedFiles/Credit_Risk/Library/RMA_Journal/Construction_Issues/A Written Policy for Lending to Contractors.pdf.*

4. Williams, Scott C.; LeVan, Mary Paty Lynn; Rice, Melissa; & Tyszka, John. "Project Capital and Financing Structure and Its Impact on Project Completion." 2019 Fidelity & Surety Law Spring Conference. American Bar Association. May 10, 2019. *www.americanbar.org/content/dam/aba/administrative/tips/meetings/2019/friday_all_fslc_spring_2019.pdf.*

5. *Selective Insurance Company of America v. Environmental, Safety & Health, Inc.* No.: 3:14-CV-531-TAV-CCS (E.D. Tenn. Mar. 3, 2015) (declining to dismiss conversion claim asserted by surety against bank based on bank's sweeping of progress payments received in contractor-borrower's account).

6. §145:36. New York Practice Series, Commercial Litigation in New York State Courts. Thompson Reuters. 2022.; *In re MPM Silicones, L.L.C.* 596 B.R. 416 (S.D.N.Y. 2019).

7. UCC §1-310 ("an obligation may be issued as subordinated to performance of another obligation of the person obligated, or a creditor may subordinate its right to performance of an obligation by agreement with either the person obligated or another creditor of the person obligated); see also *First National Bank of Hollywood, et. al. v. American Foam Rubber Corp.* 530 F.2d 450 (2d Cir. 1976) ("this Circuit has favored the recognition of priorities based upon the 'lawful contractual arrangement between the parties'"); *Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd.* (In re Ion Media Networks, Inc.), 419 B.R. 585 (Bankr. S.D.N.Y. 2009) ("Affirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation … plainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled").

8. §30-6. *White and Summers' Uniform Commercial Code* (Practitioner Treatise Series). Volume 4, 6th edition. (Article 9 of the UCC only applies to consensual security interests and "conflicts between the rights of the surety and third parties must be resolved outside Article 9" because the surety's subrogation claim is not consensual).

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