

FINISHING CONTRACTORS ASSOCIATION
**CONTRACT
 INSIGHT**

TRUST BUT VERIFY “RIGHT-TO-AUDIT” PROVISIONS

One of Ronald Reagan’s most frequent comments regarding U.S.–Soviet relations was, “Trust, but verify.”

While relations between subcontractors, owners and general contractors do not rise to Cold War tension levels, President Reagan’s motto rings increasingly true with respect to modern construction contracts.

General contractors are expected to pay subcontractors, laborers, and material suppliers from construction project funds. A general contractor may fail to make payments for a number of reasons:

- Spending the money for personal needs.
- Juggling the funds between projects to pay debts.
- Diverting funds (which may be a last desperate act to stave off insolvency, as the contractor may use the money to keep its business afloat).

What is a subcontractor to do to protect itself from one of these occurrences? A right-to-audit clause can help expose problems early and limit exposure.

WHAT IS A RIGHT-TO-AUDIT?

A right-to-audit is a provision in a contract which provides a subcontractor or owner with the right to review a contractor’s accounting records to ensure proper payments are being

made under the contract. Right-to-audit clauses vary depending on the negotiated provisions of the contract, but all involve confirming the party being audited is correctly handling project funds.

WHY IS A RIGHT-TO-AUDIT IMPORTANT?

The construction industry is under intense pressure, especially in the current market for single and multi-family residential projects. The purpose of a right-to-audit clause is to limit the financial exposure of subcontractors and owners. For example, a general contractor may not make payments to subcontractors, despite having received payments from the owner. Serious problems arise when financial hardships are discovered too late. By the time a problem is discovered, an owner or subcontractor may already be substantially exposed. As a preemptive device, and to encourage general contractors to maintain up-to-date financial statements, it is important that owners and subcontractors have the ability to audit a general contractor's funds to ensure that finances are proper and payments are being correctly disbursed.

CURRENT DETERRENTS— CRIMINAL AND CIVIL SANCTIONS FOR CONTRACTOR IMPROPRIETY

A number of states have enacted legislation that treat payments received by a general contractor for the labor and materials supplied by its subcontractors as payments held in trust. General contractors that misuse funds by not paying subcontractors have engaged in “theft by contractor.” General contractors doing business in these states are deemed fiduciaries of the subcontractors and suppliers for whose labor and material they receive payment. A fiduciary owes the highest duty of loyalty to those to whom the obligation runs and may be penalized criminally or civilly for using funds for an illegitimate purpose. For example, Minnesota, Wisconsin and Colorado have strong theft by contractor statutes that can put a contractor in jail for misusing payments made under a contract.

Wisconsin

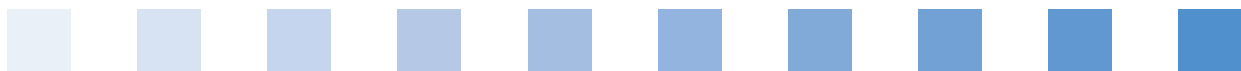
Wisconsin's Construction Trust Fund Statute sets forth in the construction lien law safeguards against contractor misappropriation in private construction projects by creating trust funds for the benefit of owners, laborers, and suppliers. (Wis. Stat. § 779.02(5)). The main purpose of the trust fund statute is to ensure payment to labor and material suppliers, thereby protecting the owner from having to pay twice for improvements.

The statute provides that any monies paid by an owner to a general contractor or subcontractor for improvements constitute a “trust” in the hands of the general contractor or subcontractor for payment of all claims due or to become due for labor and materials used on a project. The use of the funds for any other purpose constitutes theft by contractor and is punishable under Wis. Stat. § 943.20. If the general contractor is a corporation, the misappropriation is deemed theft by the officers, directors, or agents of the corporation who are personally responsible for the misappropriation.

Minnesota

Minnesota Statutes Section 514.02 is similar and has several sections which are important for all subcontractors to understand. Money paid to a general contractor by an owner does not belong to the general contractor until all subcontractors and suppliers have been paid in full. The money is to be held by the general contractor in constructive “trust” for the benefit of people who supply labor and materials. This does not mean the general contractor must open a separate bank account for this money, but instead the general contractor may not use any of the money for the general contractor's personal use, until all subcontractors and suppliers on the project have been paid. It means no profit or compensation to the general contractor may be taken until the job is completed and all other subcontractors and/or suppliers have been paid.

For residential jobs, if a general contractor uses the money for anything other than payment of subcontractors and suppliers, it is a theft and punishable



as a gross misdemeanor. This means that the general contractor could go to jail, pay a fine, or both. Similar to Wisconsin, owners of a corporation or other entity in Minnesota are personally liable for the money. Operating as a corporation, will not protect the general contractor from criminal action or civil lawsuit. For a residential construction projects, every shareholder, officer, director or agent of the corporation who receives money can be held liable. This includes payment of all attorney fees. The corporate shield will not protect a contractor who misuses money from a job.

Colorado

Colorado also imposes criminal penalties on a contractor that received advances but failed to make payments to subcontractors and materialmen. (C.R.S.A. § 18-4-401 and § 38-22-217.) Colorado views funds disbursed to a contractor to be “held in trust for payment.” Failure to make such payments will result in the imposition of criminal and civil liability.

Even with criminal and civil sanctions as a deterrent against contractor impropriety, improper actions still occur. The majority of improper actions are the result of desperation, perceived necessity or fraud. As a result, subcontractors and owners must be diligent and proactive to ensure that their finances are being distributed correctly. The solution: a right-to-audit clause.

AIA AND CONSENSUSDOCS RIGHT-TO-AUDIT PROVISIONS

AIA 2007 A201, Section 9.6.4 includes a provision which gives an owner the right to request written evidence from a general contractor that it has paid for subcontracted work and supplies. If the general contractor fails to furnish such evidence within seven days, the owner shall have the right to contact subcontractors and ascertain whether they have been paid. The AIA does not have a reciprocal right-to-audit provision in favor of a subcontractor to determine whether any delay in payment is a result of the owner’s failure to pay, or impropriety by the general contractor.

The ConsensusDOCS do not contain formal “right-to-audit” clauses, however they do contain an “owner’s

ability to pay” clause which gives both general contractors and subcontractors the ability to obtain evidence to confirm an owner’s solvency.

ConsensusDOCS 750, Section 4.2 provides that a “Subcontractor shall have the right upon request to receive from the contractor such information as the contractor has obtained relative to the owner’s financial ability to pay for the work . . . If the subcontractor does not receive the information . . . with regard to the owner’s ability to pay for the work as required by the contract documents, the subcontractor may request the information from the owner or the owner’s lender.” The AIA documents do not contain similar “ability to pay” provisions.

As neither the AIA nor ConsensusDOCS gives a subcontractor a right-to-audit, these clauses may be added as supplemental provisions to the general contract form.

EXAMPLE PROVISIONS

The following could be added to the Supplemental Provisions of AIA or ConsensusDOCS, or could be added as a clause in any standard form contract used by subcontractors:

“The subcontractor shall have the right, upon written request, to receive from the contractor financial information, records and documentation demonstrating payments received from the owner under the contract, have been timely forwarded to the subcontractor. If the subcontractor does not receive the information requested within seven (7) days, the subcontractor may seek such information directly from the owner. In the event subcontractor receives information indicating that payments have not been forwarded to the subcontractor consistent with the terms of the contract, the subcontractor may immediately suspend work and seek remedies for contractor default under the contract.”

As with all contracts, it is essential that contractors and subcontractors consult with their counsel to make sure any terms inserted into a contract are consistent with the laws of their state and their existing contracts.

CONCLUSION

In a trustworthy world, a right-to-audit clause would not be necessary. However, especially in the current economic climate, even “good” people are running into financial difficulties and improperly redirecting payments. Right-to-audit clauses can provide security and prevent subcontractors and owners from getting too deep into a bad situation. Be pro-active and pre-empt disaster with a right-to-audit clause. Take the advice of Ronald Reagan: “Trust, but verify.”

A Note from Stephen Yoch:

A “right-to-audit” clause should not be confused with “right to prompt payment” or “verification of payment” provisions. For example, AIA 2007, A201 §9.6.4 provides that if a contractor fails to furnish evidence of payment within 7 days, the owner has the right to contact the subcontractor to ascertain whether payment has been made and, if not, make payments directly.

These provisions address situations after a contract has been signed and the parties are seeking to ensure payment. In contrast, the “right-to-audit” provisions contractors and subcontractors are seeking verifications of the owners’ abilities to pay before and after the contract has been signed, and before non-payment problems have occurred.

Author Stephen Yoch, attorney and contract litigator, welcomes your comments and suggestions. Email syoch@felhaber.com or send them to Amelia Townsend, FCA Director of Communications, atownsend@finishingcontractors.org.

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