

FINISHING CONTRACTORS ASSOCIATION

GETTING PAID IN TROUBLED TIMES: IMPORTANT CONTRACTUAL ISSUES

It is more important than ever for subcontractors to do everything they can to ensure their rights to payment. There are important actions and contractual provisions which can help ensure payment. There are also provisions general contractors and owners may want to impose that can undermine a subcontractor's likelihood to receive payment. This article, while not comprehensive and subject to differences in the various states, provides a useful framework for ensuring that subcontractors get paid.

THE "DO'S" OF GETTING PAID

There are a few things a subcontractor should do in order to maximize the likelihood of payment. At a minimum, the following issues should be raised with owners and general contractors so the subcontractor can enter into the transaction knowing whether payment could become a problem.

1. Mechanic's Liens

Owners and the subcontractors holding mechanic's liens are most entitled to the full satisfaction of their claims. Although statutes vary greatly from state to state, all states grant contractors, subcontractors, suppliers, and others the right to have unpaid bills satisfied out of the real property that was improved by the labor or materials. A mechanic's or materialmen's lien can be a very valuable tool to a subcontractor or supplier, because the "automatic stay" in bankruptcy may not bar the subcontractor from suing a non-debtor third party (e.g., an owner of property whose property was improved as a result of the subcontractor's work) to enforce its lien rights.

Mechanic's lien laws are very technical and lien rights can be lost if the subcontractor or supplier does not comply precisely with the mechanic's lien statutes. For example, creation and perfection of a mechanic's lien almost always requires a public filing or recording of some notice of the lien claim within a fixed period of time following completion of the work or provision of the materials. Additionally, it is also often necessary to personally serve the property owner (and sometimes the general contractor and other parties) with a notice of the lien and a demand for payment.

A mechanic's lien can be a very useful tool in the event a general contractor files for bankruptcy. While it may irritate a general contractor or owner that a subcontractor has provided pre-lien notice or filed a mechanic's lien, allowing lien rights to lapse almost always removes a subcontractor's greatest tool in ensuring payment. In these challenging times, even if the owner or general contractor is a "friend," mechanic's lien rights should still be asserted.

2. Determination of Owner's Ability to Pay

Before or during the contract, it is crucial that subcontractors be able to assess whether they will be paid for work performed on the project. "Owner ability to pay" clauses give contractors and subcontractors the ability to obtain such evidence. An "owner ability to pay" clause *may* provide the subcontractor authority to obtain the owner's financing information (either from the general contractor or the owner) depending upon the language of the clause. Both the AIA A201-2007 and the ConsensusDOCS 750, provide some mechanism for obtaining information regarding an owner's ability to pay.

AIA A201-2007

§ 2.2 INFORMATION AND SERVICES REQUIRED OF THE OWNER

§ 2.2.1 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.

The AIA contract specifically gives the contractor the right to terminate the agreement if the owner fails to promptly furnish reasonable evidence of financing upon the contractor's request. AIA A401-2007 does not specifically allow the subcontractor to request such information from the owner, but does allow the subcontractor to terminate the subcontract under the same circumstances that the contractor can terminate its contract. Thus, if the subcontractor does not receive reasonable evidence of financing, the subcontractor can terminate its subcontract.

ConsensusDOCS 750

4.2 OWNER'S ABILITY TO PAY¹

4.2.1 The 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, including any subsequent material variation in such information. The Contractor, however, does not warrant the accuracy or completeness of the information provided by the Owner.

4.2.2 If the Subcontractor does not receive the information referenced in Subparagraph 4.2.1 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.

While the ConsensusDOCS contract gives a subcontractor the specific right to seek financial information, the contract does not give a subcontractor the specific right to terminate the contract based on an owner's or contractor's failure to provide the requested information.

An "ounce of prevention is worth a pound of cure" in assessing an owner's ability to pay. While it takes time and effort to determine the viability of an owner, if a subcontractor is making a substantial financial commitment to a project, obtaining information regarding the owner's ability to pay is crucial both in determining whether to proceed with the project and in the event a default later occurs.

¹ The ConsensusDOCS 750 provides a seven-day period for the general contractor to provide written notice to the subcontractor of any disapproval or nullification of all or part of the subcontractor's payment.

8.2.7 PAYMENTS WITHHELD. The Contractor may reject a Subcontractor payment application in whole or in part or withhold amounts from a previously approved Subcontractor payment application, as may reasonably be necessary to protect the Contractor from loss or damage for which the Contractor may be liable and without incurring an obligation for late payment interest

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No later than seven (7) days after receipt of an application for payment, the Contractor shall give written notice to the Subcontractor, at the time of disapproving or nullifying an application for payment stating its specific reasons for such disapproval or nullifying an application for payments are removed, payment will be promptly made for the amounts previously withheld.

3. Obtaining Personal Guaranties

Wherever possible, subcontractors should seek “personal guaranties” from owners or general contractors to whom material or labor is provided. This is especially true when, for whatever reason, there will be no mechanic’s lien rights to secure payment.

The old adage “the world belongs to those who ask” is especially apropos when it comes to personal guaranties. That is, when submitting a subcontractor agreement to an owner or general contractor, there is little downside to including a separate “guaranty” for signature by the owner or general contractor if a default occurs. A subcontractor with a signed guaranty will be in a good position to collect in the event of a default. Conversely, if the owner or general contractor refuses to sign the guaranty, then the subcontractor will know that collection may prove problematic. In any event, obtaining a guaranty is one of the best ways of ensuring payment.

4. Termination of Contract

If an owner or general contractor fails to make payments under a contract and the subcontractor has not yet completed the project, threatening to terminate the contract or stopping work can be an effective way of ensuring payment.²

Both the AIA and ConsensusDOCS contracts allow a subcontractor to terminate the contract in the event of nonpayment. These provisions permit a subcontractor to get out of a contract when the general contractor was required to make payment under the terms of the contract, but failed to do so.

AIA A401-2007

§ 7.1 TERMINATION BY THE SUBCONTRACTOR

The Subcontractor may terminate the Subcontract for the same reasons and under the same circumstances and procedures with respect to the Contractor as the Contractor may terminate with respect to the Owner under the Prime Contract, or for nonpayment of amounts due under this Subcontract for 60 days or longer. In the event of such termination by the Subcontractor for any reason which is not the fault of the Subcontractor, Sub-subcontractors or their agents or employees or other persons performing portions of the Work under contract with the Subcontractor, the Subcontractor shall be entitled to recover from the Contractor payment for Work executed and for proven loss with respect to materials, equipment, tools, and construction equipment and machinery, including reasonable overhead, profit and damages.

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² “Termination” is different than withholding work discussed below. “Termination” contemplates irrevocably terminating the contract, whereas merely withholding work constitutes a suspension of work pending payment.

ConsensusDOCS 750

10.8 TERMINATION BY SUBCONTRACTOR

If the Subcontract Work has been stopped for thirty (30) Days because the Subcontractor has not received progress payments or has been abandoned or suspended for an unreasonable period of time not due to the fault or neglect of the Subcontractor, then the Subcontractor may terminate this Agreement upon giving the Contractor seven (7) Days' written notice. Upon such termination, Subcontractor shall be entitled to recover from the Contractor payment for all Subcontract Work satisfactorily performed but not yet paid for, including reasonable overhead, profit and attorneys' fees, costs and expenses

While terminating a contract is a Draconian remedy, if a subcontractor is not getting paid, it may be necessary to force the owner or general contractor's hand in order to get funds.

5. Withhold Work

Generally speaking, a subcontractor may suspend its services for reasons of nonpayment if, and only if, the general contractor's failure to pay constitutes a "material breach" of the agreement.

The question then becomes, "What constitutes a material breach/violation of a contract?" A material breach is a violation of the contract that goes to the very heart or essence of the agreement. In other words, a material breach is a serious, not a trivial, violation of the agreement. Whether or not a breach meets this standard is determined by the facts and circumstances of each case and, most importantly, the language in the agreement. Numerous courts have held, however, that under certain circumstances, a general contractor's failure to make payments to a subcontractor can constitute a material breach of a construction contract. See e.g., Henson Construction Co. v. Davis, 43 P.3d 417 (Ok.App. 2002); Manganaro Corp. v. Hitt Corp., 193 F.Supp.2d 88 (D.D.C.2002).

Before deciding to suspend performance, the following factors should be carefully evaluated.

1. Review the subcontract carefully. A subcontractor is justified to suspend performance if, and only if, the general contractor has committed a material breach/violation of the contract. The contract language will control this determination. Before doing anything, a subcontractor must review the contract provisions regarding the general contractor's duty to pay. The subcontractor should determine if the contract has an unrestricted "pay-when-paid" clause (discussed below) or equivalent language. The subcontractor should find out if the contract has a "time is of the essence" clause. Does it contain language concerning attorney's fees (i.e., if the subcontractor is sued and loses, does the subcontractor have to pay the general contractor's attorney's fees)?

2. Attempt to determine why the general contractor is withholding payment from the subcontractor. Is there a legitimate dispute over an invoice? Is there another legitimate reason (i.e., contractually based) that allows the general contractor to withhold payment? Is the subcontractor in material breach of the contract?

3. Evaluate the risks. Suspending performance is a drastic remedy and it should not be taken lightly. If a subcontractor is not legally justified in suspending services, it will be the party in breach of the agreement. In other words, a subcontractor must proceed cautiously in this area and understand the business risks.

4. Consider talking to the general contractor. It may be possible to “iron out” differences with the general contractor by simply talking. Perhaps the reason(s) for nonpayment is based on a misunderstanding.

5. Talk to a lawyer. If a subcontractor walks away from a project, the subcontractor will probably get sued. A lawyer can give guidance not only about a specific contract but also the law.

6. Theft by Contractor

An unfortunate, yet all-too-common, scenario in the construction industry occurs when an owner pays the general contractor, but instead of paying the subcontractors for their contributions to the project, the general contractor uses the funds for another purpose. What are the subcontractors’ options in this predicament? A remedy may be available through a “trust fund” or “theft by contractor” statute. Although these statutes vary by state, many provide criminal penalties against general contractors and civil remedies exist for subcontractors when subcontractors do not receive payment.

A variety of statutory remedies are available to subcontractors or sub-subcontractors who remain unpaid, including:

- i. A right to a mechanic’s lien, available to those who work on private projects;
- ii. A labor and materials payment bond secured by a surety, available to those who work on public projects;
- iii. A “stop notice,” which forces an owner to withhold from the general contractor enough funds to cover the subcontractor’s claim of indebtedness;
- iv. Remedies under “trust fund” statutes, which impose a trust on the funds the owner pays to the general contractor for the benefit of the subcontractor; and

- v. Criminal penalties exist in nearly half of the states, which make it a crime for the general contractor to fail to pay its subcontractor after the general contractor has received payment for the work done by the subcontractor. These provisions are sometimes part of a trust fund statute and other times are separate from the trust concept.

Theft-by-contractor statutes can have devastating effects on general contractors who fail to make timely payments. For example, in a New York case, after receiving the seventh of eight installment payments from the owner on a \$230,000 project, the general contractor deposited the money into his business account. Although he owed money to the subcontractors for work they had performed on the project, the general contractor withdrew \$2,000 from the account for his own use and was charged with larceny for failing to pay construction trust funds under the New York lien law. The court found the larcenous intent element satisfied by testimony from the owner that the general contractor admitted that he would abandon the job, because his expenses were eating into his profit and all the money coming out of the job thereafter would be owed to suppliers.

In some states, such as Wisconsin, not only is a general contractor liable for misappropriation of the funds, but if the general contractor is a corporation, liability extends to any officer, director, or agent of the corporation, who is responsible for misappropriating the funds. Wis. Stat. § 779.05(2). Moreover, in other states, the shareholders, officers, directors, or agents of a company, who are not responsible for the theft, but who knowingly receive proceeds of the payment, may be subject to civil liability.

If a subcontractor has learned that a general contractor is not forwarding payment, the subcontractor should immediately contact its lawyer and act promptly to protect its rights. The severe consequences which can be imposed on general contractors, gives subcontractors significant options in pressuring general contractors to make payment.

THE “DON'TS” IN GETTING PAID

1. Paid-When-Paid

A subcontractor's ability to collect amounts owed depends upon the language of the contract. Some contracts contain “pay-when-paid” or “pay-if-paid” clauses, which makes pursuing payment by a subcontractor more difficult. See “Pay When Paid” vs. “Pay If Paid” Clauses: Mystery vs. Myth, John P. Ahlers, Construction Law Blog, March 17, 2008. A “pay-when-paid” clause generally requires that a contractor pay the subcontractor within a certain period of time after receiving payment from the owner, rather than a certain period of time after the work was performed. The clause operates to postpone payment for a reasonable time rather than excusing the general contractor from all obligations to pay a subcontractor's valid invoice. “Pay-when-paid” clauses do not eliminate a subcontractor's ability to seek payment from the general contractor for work performed. However, the subcontractor will be forced to incur the costs of carrying the debt until a “reasonable time” has passed.

“Pay-if-paid” clauses provide that contractors are not obligated to make payment unless and until the contractor receives payment from the owner. A subcontractor does not have a remedy against the general contractor if the general contractor has not received payment from the owner. Courts and legislatures around the country have generally viewed “pay-if-paid” clauses with disfavor. Standard AIA and ConsensusDOCS contracts no longer include “pay-if-paid” clauses. However, subcontractors should examine their individual contracts to determine their ability to pursue the general contractor for payment.

A. The Clause—Defined

Some general contractors have shifted responsibility of collection to subcontractors through “pay-when-paid” clauses. In effect, the provision seeks to transfer from the general contractor to the subcontractor the credit risk for an owner’s nonpayment. The following are two examples of such clauses:

- *Receipt of funds by the Contractor from the Owner is a condition precedent to the Contractor’s obligation to pay Subcontractor under this Agreement, regardless of the reason for the Owner’s nonpayment, whether attributable to fault of the Owner, Contractor, Subcontractor or due to any other cause.*
- *The receipt of . . . payments by the [general contractor] is a condition precedent to payments to the subcontractor.*

B. Treatment by the States

A number of states have treated “paid-when-paid” clauses as unenforceable and void as a matter of law. A smaller number of states, led by Florida, have found such clauses to be enforceable against subcontractors. This harsh reading of the contract can have devastating results for subcontractors when owners do not pay. The majority of states read paid-when-paid clauses to merely provide (regardless of the language of the clause itself) a reasonable time for payment by the general contractor to the subcontractor without relieving the general contractor of its obligations to pay subcontractors.

Unless a subcontractor knows that it is in one of the states that has refused to enforce these provisions, subcontractors should proceed carefully. The implications of an owner failing to pay for work with no recourse against the general contractor are obvious. Subcontractors usually provide substantial value to a project through labor and materials. The general contractor often provides only job oversight. Therefore, the party taking the significant financial “hit” is the subcontractor.

The safest and best approach is to remove these clauses whenever they are included in a contract, regardless of the state in which the subcontractor is doing business.

2. Accepting “Payment in Full”

In the construction business, it seems a relief to receive any payment, even a partial payment. For subcontractors, the risk of nonpayment seems even greater than the risk for general

contractors. Subcontractors are often concerned about whether the general contractor will get paid and whether the general contractor will, in turn, pay the subcontractor. But a subcontractor should not be too quick to cash that check when it finally arrives or it may find itself without a remedy to recover all amounts.

Imagine that a subcontractor has been hired by a general contractor to install new floor covering in a building. In response to the invoice, the general contractor refuses to pay for the full amount of the contract, claiming the work was deficient. The general contractor provides a check for a portion of the invoiced amount that says “paid in full,” “final payment,” or contains similar language. Happy to receive any payment, the subcontractor ignores or misses the notation and cashes the check. Do not assume that once the check is cashed that the general contractor can be sued for the balance due. Under such circumstances, a subcontractor may have unwittingly extinguished any right it once had to pursue a claim against the general contractor for the remainder of the money. This situation is legally referred to as “an accord and satisfaction” and is the law in virtually every jurisdiction in the United States.

What are a subcontractor’s options when it receives a check for partial payment? Unfortunately, in this situation, few choices exist. A subcontractor can accept the check and forego any opportunity to collect any remaining amounts due under the contract. (Some jurisdictions allow return of the money within 90 days after cashing the check.) To preserve the right to collect monies due, return the check to the general contractor and negotiate a different settlement, or bring a lawsuit for the full contract price. In some jurisdictions, a subcontractor will be deemed to have accepted the offer if the check is held for an unreasonably long period of time, so subcontractors should make prompt decisions.

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; or 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).

The hope is that the situation will be avoided because a subcontractor has engaged in an audit of the owner to determine solvency (see discussion above). Likewise, to the extent the general contractor is not paying the full amount because of a “theft by contractor” situation, the subcontractor can also seek civil and criminal penalties for payment. However, if these situations do not apply, and there is no paid-when-paid clause present, then the subcontractor is faced with difficult business and legal decisions, which should be made carefully and not as a snap decision.

3. Providing Personal Guaranties

As discussed above, as much as possible, a subcontractor will want to obtain personal guaranties from general contractors or owners to secure payment. Conversely, as much as possible, a subcontractor should avoid providing personal guaranties.

There are a few important rules in understanding personal guaranties.

A. Less is Not More for Personal Guaranties.

A “red flag” in reviewing any personal guaranty is that short and concise guaranties can often have very broad implications. For example, “John Jones does hereby personally guaranty any and all debts or obligations of ZZZ Corporation.” This is a very broad and dangerous guaranty for the guarantor. The guaranty contains none of the limits referenced below, and should be a “red flag” to make necessary changes.

B. The World Belongs to Those Who Ask

There is little downside in requesting a lender make modifications to the guaranty. First, none of the requested modifications listed below are “unreasonable” and a lender should not be put off by such a request. Second, if the lender is inflexible and requires signature of the guaranty in the form presented (even though it has very onerous terms), the guarantor is clearly on notice that the lender intends to be aggressive, and that the guaranty will be taken seriously.

C. Limiting Guaranties

A business owner can do a few things to limit the reach of a personal guaranty:

1. **Have More Than One Option.** When looking to borrow, have more than one option. Some banks and other financial institutions, and some trade creditors, may be willing to limit the reach of a personal guaranty when competing for business.

2. **Limit the Exposure/Business Partners.** Ask the lender to limit exposure under a personal guaranty to a percentage interest in the company. For example, if a subcontractor owns a 33.33% interest in a company, a lender may accommodate a request to limit the subcontractor’s liability under a personal guaranty to one-third of any claimed amount.

3. **Spouse as Business Partner.** Consider whether to include a spouse as a co-owner of a business. Banks and other lenders typically want all those with an ownership interest in the business to sign a personal guaranty when the business takes out a loan. (Some banks will waive the personal guaranty requirement if the business partner owns 20% or less of the company.) While there are many factors to consider, limiting a spouse’s exposure to business debts is an important goal.

4. **Limit the Length of the Personal Guaranty.** If the amount of the loan will be reduced over time, ask the lender to consider limiting the personal guaranty to the first two or three years of the loan with the thought that real estate or other assets which secure the loan will, at that point, provide adequate protection for repayment to the lender.

5. **Claims Against the Guarantor Should Be the “Last Resort” for the Lender.** The guaranty should contain a provision that the lender must first seek to enforce its claims against the party borrowing the money (i.e., the business entity), and then seek to enforce claims against the guarantor. This, in many cases, forces the lender to work with

the business borrower, rather than allowing the lender to go against the guarantor as the “easy target.”

6. **Mandatory Deposit Provisions.** Some guaranties require the guarantor secure the guaranty by maintaining an account with a specified minimum amount of funds, or providing other assets of the guarantor for the benefit of the lender. As discussed below, these provisions give the lender a tremendous advantage in collection and should be avoided wherever possible.

7. **Avoid Self-Renewing or Blanket Personal Guaranties.** Often, when working with suppliers, a business owner may sign a personal guaranty at the start of the relationship without realizing that this personal guaranty will continue indefinitely or renew automatically.

D. **No Second Chance**

After the guaranty is signed, rarely can a subcontractor change or modify the scope or terms of a guaranty without the consent of the lender. The lender has little incentive to “soften” or lessen the scope of a signed guaranty. The only practical way to renegotiate a guaranty is for the subcontractor to demonstrate to the lender that it is going to stop doing business with the lender and that the guarantor and the business entity have the ability to take their business elsewhere.

CONCLUSION

Subcontractors, more than ever, are getting “stuck” with performing valuable improvements to real property, and not getting paid. The best and most effective way of getting paid is to obtain mechanic’s liens rights and/or personal guaranties. However, as discussed above, there are a number of contract provisions that can be included that give a subcontractor greater confidence in the likelihood of getting paid, and other provisions which should be, whenever possible, avoided. In these troubled times, an “ounce of prevention is worth a pound of cure” and to the extent subcontractors can engage in activities to increase their likelihood of collection before problems occur.

(It is important to keep in mind that this article is only a general overview of the law in this area. Because laws in individual states and the facts and circumstances of each case may vary, it is recommended that you seek competent legal advice before making the decision about how to proceed when you are faced with the situation outlined in this article.)