

NAVIGATING THE PAYMENT

MINEFIELD

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by Gregory R. Shaughnessy

Payment issues on construction projects in California are becoming increasingly more complex and regulated. In the early 1990s numerous “prompt payment” statutes were enacted and amended and in 1998 changes were made to these statutory schemes. Recently California courts have clarified that “pay if paid” clauses are unenforceable. Finally, effective January 1999, new legislation allows unpaid contractors to suspend work without liability under certain conditions.

In responding to these developments, general contractors must undertake careful planning and risk management in order to avoid the “land mines” of owner insolvency and prompt payment penalties. Simultaneously, contractors should exercise their statutory payment rights to pressure owners to release timely payments.

This article will highlight some important aspects of the “pay if paid” dilemma, review recent legislation (both successful and unsuccessful) initiated in response to the “pay if paid” decisions and, finally, organize and summarize the current prompt payment legislation in California.

1. “Pay If Paid”

In 1997 the California Supreme Court declared that true “pay if paid” clauses in subcontracts on private works of improvement are unenforceable. Wm. R. Clarke Corporation v. Safeco Insurance Company of America (1997) 15 Cal. 4th 882. The court found that “pay if paid” clauses result in an “impermissible

indirect waiver or forfeiture of the subcontractor’s constitutionally protected mechanic’s lien rights in the event of nonpayment by the owner.”

Clarke was quickly followed by a California Court of Appeal decision which applied this rule to public projects. Capitol Steel Fabricators, Inc. v. Mega Construction Co., Inc. (1997) 58 Cal. App. 4th 1049. The facts of this case were somewhat unusual. The general contractor, Mega Construction Co., Inc., had settled with the owner, the Long Beach Unified School District. Before receiving the settlement proceeds from the owner, Mega had paid its subcontractor, Capitol Steel Fabricators, Inc., the entire principal amount of its claim. The subcontractor’s claim included \$11,000 in extra work claims the contractor had attempted to pass through to the owner.

Capitol Steel’s remaining claims involved attorney’s fees and interest for the three year period of non-payment. The court initially found that the subcontract contained a true “pay if paid” clause pursuant to which “[i]f Mega, the general contractor, were never paid, Capitol would be uncompensated.” The court concluded that a “general contractor’s liability to its subcontractor for work performed on a public works project may not be made contingent on the governmental entity’s payment to the general contractor in a factual scenario such as is present in this case.”

California law now appears to clearly place the risk of owner insolvency on general contractors

on both private and public projects. The general contractor must make payment to the subcontractors regardless of whether payment is ever received from the owner.

These decisions leave many important questions unresolved. For example, neither decision discussed whether a “pay if paid” clause could be relied upon to justify a mere delay in payment in a case where it appeared that the general contractor might eventually receive payment, or the extent to which a subcontractor might be required to participate in a claims prosecution process prior to receipt of payment.

2. Steps to Address the “Pay If Paid” Dilemma

These decisions are an obvious “wake up call” for general contractors. It is not prudent to undertake a private project relying solely on mechanic’s lien rights to secure payment. General contractors should take additional steps to reduce the risks of owner insolvency and will also need to revise the payment terms in their subcontract and purchase order forms. Some relief is also occurring through remedial legislation.

a. Reducing the Risks of Owner Insolvency

Owner insolvency will continue to be an issue primarily on private projects. Many methods exist for reducing the risks of private owner insolvency. The specific methods employed will depend on the nature of the project and the bargaining power of the parties.

In addition to conducting research into the financial resources of the owner, a contractor can request the owner to provide security in the form of a standby letter of credit or bond. Certainly any general contractor that is asked to post a payment bond may respond by

requesting an owner of questionable financial resources to also provide security.

Contractors should consider the following contractual provisions to obtain added protection from owner insolvency:

- i. Payment to the Contractor of a substantial advance payment that is proportionally reduced with subsequent payments. An owner may obtain security by the contractor’s provision of a bond to secure the advance payment.
- ii. Disburse all or a portion of the construction loan funds through use of an escrow account.
- iii. Give the contractor the right to suspend work within a brief period of time after the event of non-payment.
- iv. Require the owner to provide evidence of its ability to finance the work prior to commencement of the work and periodically thereafter. Specific provisions may be included allowing the contractor to contact the construction lender and for the lender to provide specified information to the contractor.

b. Subcontract Terms

Many contractors have revised their subcontract forms to delete the more obvious “pay if paid” provisions from the subcontract payment clauses. However, these subcontract forms should be thoroughly reviewed, as many subcontracts also contain “pay if paid” language in their clauses on changes, extra work and claims. Furthermore, purchase order forms should also be reviewed and modified, as the logic of the Clarke and Capitol Steel decisions applies with equal force to direct suppliers of material and equipment.

The Capitol Steel decision suggests that “pass-through” clauses for extra work claims by subcontractors may also be unenforceable where the owner is insolvent. Capitol Steel involved subcontractor claims for extra work that the contractor asserted were the owner’s responsibility. In invalidating the “pay if paid” clauses, the court did not distinguish between the extra work claims and other claims.

Subcontractors will surely rely on Clarke to argue that “pay if paid” pass through/extra work clauses are unenforceable. Certainly one interpretation of Clarke could be to invalidate any subcontract language that would impair a subcontractor’s mechanic’s lien rights or reduce the value of the lien.

Subcontractors may even rely on these decisions to attempt to invalidate “no pay for delay” clauses that provide that in the event of owner-caused delays, the subcontractor’s sole remedy is an extension of time. Contractors may counter such arguments by relying on Lambert v. Superior Court (1991) 228 Cal. App. 3d 383, which held that delay damages may not be included in a mechanic’s lien.

General contractors should attempt to include provisions in their subcontracts and purchase orders that at least delay payment until the contractor has taken all reasonable steps to procure payment from the owner. The AGCC has already included the following language in a 1998 revision to Form AGCC-3, Long Form Standard Subcontract:

If owner or other responsible party delays in making any payment to Contractor from which payment to Subcontractor is to be made, Contractor and its sureties shall have a reasonable time to make payment to Subcontractor. “Reasonable time” shall be determined

according to the relevant circumstances, but in no event shall be less than the time Contractor, Contractor’s sureties, and Subcontractor require to pursue to conclusion their legal remedies against Owner or other responsible party to obtain payment, including (but not limited to) mechanic’s lien remedies.

Contractors may also wish to consider including subcontract language that requires the subcontractors to cooperate with the contractor in all steps taken to prosecute subcontractor’s claim against the owner and which binds the subcontractor to the outcome of such proceedings.

c. 1998 Remedial Legislation

Partially in response to the Clarke decision, in 1998 two bills were introduced in the California Legislature. Assembly Bill 2280 required private property owners who enter into construction contracts for over \$1,000,000 to provide the general contractor with financial security. The security could be in the form of a surety bond equal to 50% of the contract, a letter of credit for 15% of the contract or a cash deposit equal to 3 months of payments under the contract. This bill was passed by the Assembly and the Senate, but was vetoed by Governor Wilson. There is a strong likelihood that similar legislation will be introduced in 1999, where it may stand a better chance with Governor Gray Davis.

Assembly Bill 2627 was passed and approved by Governor Wilson in September 1998, and was adopted as Civil Code Section 3260.2. This statute gives a contractor and its subcontractors a right to suspend work where an owner fails to issue payment within 35 days from the date the payment is due, provided that

“there is no dispute as to the satisfactory performance” of the contractor. There are several detailed procedural requirements, including the posting of a “10-day stop work order” and service of same on the owner, subcontractors and the construction lender. The statute only applies to contracts entered on or after January 1, 1999.

If the requirements of §3260.2 are followed, neither the original contractor nor its direct subcontractors are “liable for any delays or damages that the owner or contractor may suffer as a result” of the stoppage of work.

In practice, the suspension of work provisions of §3260.2 will probably afford little relief for contractors, as it will be extremely difficult to prove that “there is no dispute as to the satisfactory performance” of the contractor. There are almost always *some* disputes between an owner and a contractor, and under the statute it appears that *any* dispute about the contractor’s performance is enough to prevent the contractor from relying on the statute to suspend work.

A potentially overlooked aspect of the statute provides that a contractor who has served a “10-day stop work notice” and has not been paid may, at the expiration of the ten days “seek a judicial determination of liability for the amount not paid for work performed in an expedited proceeding in the superior court.” The statute does not state that the contractor must actually stop work in order to file the expedited action. Thus, §3260.2 may in effect provide a new procedural tool for unpaid contractors to use to accelerate payment of undisputed sums.

The availability of such a procedure may be seen as a balancing of the rights of contractors and owners. Property owners currently have the right to expedited court procedures to test the validity of a contractor’s mechanic’s lien. See Connolly Development, Inc. v. Superior

Court (1976) 17 Cal. 3d 803; Lambert v. Superior Court (1991) 228 Cal. App. 3d 383. Now contractors may have a procedural right to seek an expedited release of funds that would otherwise be the subject of a mechanic’s lien.

4. Summary of Prompt Payment Statutes

In 1990 there were only two statutes that expressly addressed the issue of the release of funds on construction projects - Business & Professions Code §7108.5 and Public Contract Code §10262. These statutes essentially required a prime contractor to pay a subcontractor the subcontractor’s portion of any progress payment within 10 days following the prime contractor’s receipt of the progress payment. Failure to do so was grounds for disciplinary action by the Contractor’s State License Board.

In 1990 and 1991 Bus. & Prof. Code §7108.5 was radically amended and several new statutes were added. The current statutory scheme applies to both progress and retention payments and to owners, prime contractors and subcontractors. Severe interest penalties (2% per month) apply, and there are provisions requiring the party violating the statute to pay the other side’s attorney’s fees. In some cases the terms of the statute can be varied by contract, and in others they cannot.

The primary “prompt payment” statutes and their areas of application are as follows:

Bus. & Prof. Code §7108.5

-Progress payments to subcontractors on all private and some public projects

Public Contract Code §10261.5

-Progress payments to contractors on some public projects

Public Contract Code §§10262 & 10262.5

-Progress payments to subcontractors on some public projects

Civil Code §§3260 & 3260.1

-Retention payments to contractors and subcontractors on private projects

Public Contract Code §§7107 & 7200

-Retention payments to contractors and subcontractors on all public projects

The attached chart has been prepared in order to summarize and simplify the various statutory requirements and penalties. Special attention should be drawn to whether the statutory requirements can be modified. For example, a general contractor may wish to specify that payments to subcontractors will be made 30 days after contractor's receipt of payment. This is permissible on both public and private projects, but only for progress payments, not retention.

The statutes all either refer to release of "undisputed" amounts or allow for withholding of "disputed" amounts. Civil Code Section 3260 is unique in that it provides a procedure for contractors and subcontractors to be paid the "disputed" amount. Within 10 days of written notice "that any work in dispute has been completed in accordance with the terms of the contract" the work must be accepted or

rejected, and payment must be made within 10 days following acceptance.

The owner is required to release the retention proceeds within certain specified periods following "completion." The definition of "completion" in the operative statutes is similar, but not identical. The contractor is required to release the subcontractor's portion of the progress and retention payments within a specified period following contractor's receipt.

Finally, in 1998 legislation was passed that modified some of the payment rules on public projects. The time period for the contractor's release of retention was reduced from ten days to seven days (Public Contract Code §7107) and, for subcontracts entered into after January 1, 1999, the percentage of retention proceeds withheld from the subcontractor may not exceed the percentage withheld from the prime contractor (Public Contract Code §7200).

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CALIFORNIA PROMPT PAYMENT STATUTES – JANUARY 1, 1999

PRIVATE PROJECTS

PUBLIC PROJECTS

A. Progress Payments

1. By Owner to Contractor (Civil Code §3260.1)
 - a) Time - 30 days (contract may vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * collection action - attorneys' fees, costs
2. Payment to Subcontractors (Bus. & Prof. Code §7108.5; Civil Code §3260.1)
 - a) Time - 10 days (subcontract may vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * possible disciplinary action
 - * collection action - attorneys' fees, costs

A. Progress Payments

1. By Owner/State Agency to Contractor (Public Contract Code §10261.5)
 - a) Time - 30 days (contract may not vary)
 - b) Late payments - 10% per year penalty
2. Payment to Subcontractors (PCC §§10262 and 10262.5; Bus. & Prof. Code §7108.5)
 - a) Time - 10 days (subcontract may vary)
 - b) Dispute - 150% maximum withholding
 - c) Late payments
 - * penalty - 2% per month
 - * possible disciplinary action
 - * collection action - attorneys' fees, costs

B. Retention Payments

1. Release by Owner (Civil Code §3260)
 - a) Time - 45 days (contract may not vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * collection action - attorneys' fees, costs
2. Payment to Subcontractors (Civil Code §3260)
 - a) Time - 10 days (subcontract may not vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * collection action - attorneys' fees, costs

B. Retention Payments

1. Release by Any Public Owner (PCC §7107)
 - a) Time - 60 days (contract may not vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * collection action - attorneys' fees, costs
2. Payment to Subcontractors (PCC §7107)
 - a) Time - 7 days (subcontract may not vary)
 - b) Dispute - 150% withholding maximum
 - c) Late payments
 - * penalty - 2% per month
 - * collection action - attorneys' fees, costs