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INTRODUCTION

It has been nearly a decade since the so-called great recession of 2008-10. Across much of the United States and Canada the construction trade is booming again, and the supply of labor and materials is tight. Although conditions are generally favorable for contractors and suppliers (for now), it still pays to be vigilant and proactive at the outset of a job, as well as when the time comes to get paid. For those hopefully rare occasions when getting paid promptly and in full becomes a challenge, contractors and suppliers must be familiar with the legal tools of the trade. This paper will discuss some general best practices and briefly survey the various means and methods by which contractors and suppliers may enforce their right to payment including liens, bonds, stop notices, state specific remedies, and contractual escrow.

DISCUSSION

I. General Best Practices

a. Prevention is Better Than Cure.

In almost any type of business it pays to know your customer and payment risk up front. In good economic times when new entities are forming, it is good practice to do some due diligence on the party you are contracting with before you bid the job or sign the final agreement. This may include research on the background of the company and its principals to assess financial strength and whether they have a reputation for
prompt payment and fair resolution of disputes. Even if you may have a long-standing relationship with a particular owner or general, it makes sense to periodically review your assessment of the company and make sure it is up to date. Similarly, it is always prudent to do some investigation on each new project, understand how it is being financed, and consider whether it might face any unique challenges along the way to completion. If a new customer or project appears risky or may warrant special payment terms or security it is usually best to deal with it up front. When negotiating contracts, avoid if possible any terms that hinder your right to payment such as retainage, “pay if paid” and “no damage for delay” clauses, and advance waivers of liens.

b. Be Organized and Prepared.

Once the project is underway, being prepared to collect payment is important. Project milestones, payment dates and other critical deadlines, whether arising from the contract or applicable law, should be calendared. Key contract terms and any statutes relating to change orders, payment, lien and bond claims, and dispute resolution should be re-read and fully understood. If your state’s lien laws require any kind of pre-notice, make sure that it is provided in a timely manner. Records should be well organized and readily available for review and production if needed to support a claim.

c. If Trouble Strikes, Move Quickly to Enforce Your Right to Payment.

Timing is everything in the exercise of legal remedies. It can determine the priority of your claim to payment and whether you have any claim at all. Therefore, it is critical that you meet the deadlines and requirements of your contract, your bond, and the applicable law. This is especially true in jurisdictions where strict compliance is
mandatory. Delaying action based on vague promises of payment when payment is already past due, or in the hope that the problem will resolve itself, can often lead to missed deadlines and waiver of remedies. A polite demand letter sent immediately after a missed payment date is often enough to trigger payment and at least will serve as a notice that you won’t hesitate to act when necessary. Even if the letter does not result in prompt payment the response (or lack thereof) will give you a better idea of what steps to take next.

II. Methods for Getting Paid.

The legal remedies available for collecting payment will invariably depend upon whether the project is a public or private one, and the laws of your jurisdiction. Most states have a variety of statutory payment remedies that are available as tools for an unpaid construction contractor or supplier.

a. Construction or Mechanic’s Liens

All 50 states have construction or mechanic’s lien statutes that give an unpaid contractor or supplier the right to claim a lien on a private project. Because these laws vary from state to state and have procedural and time requirements that must be met, it is critical to understand the laws of the particular jurisdiction.¹ Some states require strict compliance with the procedural requirements in order to establish a valid lien, while in other states substantial compliance is sufficient.

Other issues that regularly arise include the priority of a valid lien over other liens and mortgages, equitable liens, waiver of lien rights, the lien foreclosure process, and the defenses that may be raised by the owner. Roughly half of the states allow contracting parties to waive lien rights in advance, while the remainder of states either have statutory prohibitions against advance lien waivers by statute or refuse to enforce them on public policy grounds. Another important variation in state lien laws is whether they allow liens for the full price or just the unpaid balance. Most states allow liens for the full price of the unpaid work that has been provided by the claimant, while a minority of states\(^2\) only allow a lien for the amount of money that the owner has not already paid to the general contractor (i.e., the unpaid balance) at the time the lien is filed.

b. Bonds

For public projects, in which the doctrine of sovereign immunity generally prohibits lien claims, payment bonds are typically used for securing payment for work and materials. The Federal Miller Act, 40 U.S.C. § 270, provides the statutory framework for bond claims on federal projects, while all 50 states have “Little Miller Act” statutes based on the original version.\(^3\) Some states have passed laws that encourage the use of payment bonds on private projects as well, allowing parties to avoid altogether the possibility of liens by providing payment bonds as alternative security for payment at the outset of the project.\(^4\) The existence of a valid payment bond may be

\(^2\) Alabama, Connecticut, Delaware, Michigan, Minnesota, Mississippi, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Rhode Island, Tennessee, Texas and Virginia.

\(^3\) Id.

\(^4\) 3 Bruner & O’Connor Construction Law § 8.152.
asserted as an affirmative defense to a lien claim. In some states the posting of a payment bond will limit the owner’s liability to the amount of the bond.\(^5\)

Entitlement to payment under a bond is typically conditioned upon the contractor’s substantial compliance with the terms of the bond and the applicable statutory law pertaining to notice and documentation of the claim, and commencement of suit; the contractor establishing that it’s claim is within the bond’s coverage; and establishing that there are no defenses that would defeat or reduce the amount of the claim.\(^6\) As with insurance and bond claims in general the amount and terms of the particular bond, and the coverages provided, are important in determining whether the claim is successful. In claims against private payment bonds typical common law principals of contract law and interpretation will apply. The AIA and ConsensusDOCS are the forms most commonly used for payment bonds on private projects.

c. Stop Notices

A few states have so called “stop notice” statues that allow an unpaid subcontractor or supplier to “stop” further disbursement of project funds by giving a notice of claim to the owner or lender holding the funds.\(^7\) Stop notices are generally effective only against the money that has not yet been paid out on the project; in other words they do not require double payment from the owner and if the owner has already paid then the stop notice remedy is not available. Unlike liens stop notices do not affect

\(^{5}\) Id.

\(^{6}\) Id.

\(^{7}\) States with standalone “stop notice” laws include Alaska, Arizona, California and Washington, with California’s being the most robust. Mississippi’s stop notice statute was declared unconstitutional in 2012. Many other states, such as Texas, have variations on the stop notice concept in their lien statutes or equitable lien theories under common law.
the title to the real property being improved. What generally makes them such an effective tool is that failure to withhold the unpaid funds can make the owner or lender personally liable to the stop notice claimant. As with liens, subcontractors and suppliers must take care to comply with the procedural requirements of the applicable statute in order to have a valid stop notice claim. States typically distinguish between public and private projects in making available stop notice remedies.

d. Contractual Escrow

One payment security method that has been gaining popularity in private contracting is contractual escrow. This may be utilized in situations where the project is in a foreign jurisdiction where legal remedies for obtaining payment are less certain; when the project owner is an entity such as a Native American tribe that may have sovereign immunity from suit; or if there are heightened concerns about the viability of a project or the financial condition of the owner. When a subcontractor or supplier has sufficient bargaining power it may insist upon contract terms that require progress payments to be placed in a third-party escrow account with an escrow agent at the outset of the contract, with payment to be released upon the establishment of clearly defined milestones and performance measures.

e. Other State Specific Remedies and Considerations

Nearly all states have some variation of prompt payment laws that require the prompt payment of contract funds to contractors and suppliers. In some states the requirements only apply to public projects, while in others they apply to both public and
private or there are separate statutes for each.\textsuperscript{8} Most statutes provide time periods within which payments must be made and allow for the collection of interest and attorney fees if the deadlines are not met. The federal Prompt Payment Act, 31 U.S.C. § 3901 et seq., applies to federal projects and requires the release of payment within 30 days of the receipt of the prime contractor’s invoice. It also requires that similar payment provisions be incorporated into the subcontracts entered into by the prime contractors, and contracts between lower-tier subcontractors. State and federal prompt payment acts are intended to be compatible with contract retainage terms and will almost always allow for the withholding of amounts in the event of a good faith dispute over a retention payment.

Another available remedy may be trust fund statutes or common law trust principles, whereby payments received by a contractor for work and materials provided by its subs or suppliers are treated as trust funds and the contractors are, therefore, deemed to be fiduciaries or trustees.\textsuperscript{9} Many states also criminalize the contractor/trustee’s misapplication of funds,\textsuperscript{10} imposing severe penalties and attorney’s fee liability, which significantly raises the stakes for any contractor who fails to pass along project funds to those entitled to receive them.

In states that do not have trust fund statutes, subcontractors and suppliers have sometimes had success arguing common law equitable lien or constructive trust theories.\textsuperscript{11} Courts will typically look to the language of the contract to determine whether

\textsuperscript{8} States that require prompt payment in private contracts include Alabama, Arizona, California, Connecticut, Florida, Georgia, Maine, Maryland, Mississippi, Montana, Nevada, New Mexico, Oregon, Pennsylvania, South Carolina, Tennessee, Texas and Vermont.
\textsuperscript{9} 3 Bruner & O’Connor Construction Law, § 8.41.
\textsuperscript{10} The owners and officers of contractor entities subject to such claims can also face personal liability.
\textsuperscript{11} 3 Bruner & O’Connor Construction Law, § 8.42.
a trust has been created as a matter of law. Accordingly, incorporating “trust fund” language in contract payment terms may give rise to a valuable collection tool in the event of a misapplication of funds by a financially distressed contractor.

It may also be beneficial to take a second look at the relationship between the owner and the general contractor when determining what remedies are available to an unpaid subcontractor or supplier. Occasionally an owner will characterize a related or third party or as a general contractor when in fact that party is simply acting as the owner’s project manager or agent. If the unpaid subcontractor was hired by the owner’s project manager rather than a true independent general contractor, then the subcontractor may be excused from certain procedural requirements related to a construction lien or bond claim and may be able to assert liability directly against the owner.12

**SUMMARY**

Contractors and suppliers can never be too prepared when it comes to getting paid. Following best practices in contracting and business, and understanding your legal rights and available remedies, will help ensure that you receive payment for performance.

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