

Contractual and Federal Statutory Support for an Owner's Right to Withhold Payment for Work Performed

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Owner/contractor disputes over payments for work performed can jeopardize the success of a construction project if not promptly resolved. Accordingly, a construction contract should contain carefully crafted payment provisions that fairly balance the contractor's need for continued cash flow against the right of the owner or lender to insure timely contract compliance and project completion in order to protect their investments. This paper discusses an owner's right to withhold payment and offset amounts otherwise due a contractor. It describes how the owner might contractually protect itself in the event of payment disputes with its general contractor, within the context of federal prompt pay statutes.

Progress Payments Many standard industry forms, such as those promulgated by the American Institute of Architects ("AIA") and the Engineers Joint Contracts Documents Committee ("EJCDC"), outline the typical payment application process: the contractor submits its payment application to the architect or engineer, the architect or engineer verifies the requested amount, and the owner pays the contractor. Before making payment, however, the owner should be satisfied that the contractor has not only done the work for which it seeks payment, but has also complied with all its other contractual requirements as of the date of the pay application.

One of the most obvious, but sometimes overlooked, conditions precedent for contractor payment is to expressly require properly completed, executed, and documented payment requests. In some instances, the contract fails to detail the documentation that a contractor must submit along with its payment requests. Standard industry forms only use general language regarding the type of information the contractor must provide to receive payment, and should sometimes be modified to explicitly state what type of supporting documentation the contractor must submit with each payment request.

While these standard industry forms protect owners to a certain extent by generally requiring the contractor to submit documentation “as required by the owner,” a prudent owner may wish to expand upon that requirement by specifically delineating in the general contract, to the extent known by the owner, the information the contractor must provide prior to receiving payment. The provision below is one example of how an owner might describe the detailed conditions precedent that the contractor must satisfy before the owner is required to make payment:

As a condition precedent to the Owner's obligation to make payment to Contractor hereunder, Contractor shall provide such documentation as required by Owner in order to confirm the proper release of all construction lien rights by Contractor and any potential lienor claiming through Contractor (including, but not limited to, all subcontractors, sub-subcontractors, laborers and material suppliers), with respect to each application for payment submitted by Contractor. Each Application for Payment shall be accompanied by an updated schedule of values reflecting current approved change orders, updated as-builts, as well as a release and affidavit, [in the form attached to the Agreement as Exhibit ___], showing that all materials, labor, equipment and other bills associated with that portion of the Work payment is being requested on have been paid in full through the previous month's application for payment. Further, Contractor shall attach to each application for payment monthly updates to the progress schedule for Owner's review and acceptance. Owner shall not be required to make payment until and unless these affidavits, updated schedules, as-builts, and other required documentation are furnished by Contractor and determined by the Owner to be acceptable.

Owners can also require that a contractor provide an additional certification regarding the status of claims, liens, and other encumbrances, and waiving any claims by the contractor not specifically reserved. This certification and the pay application as a whole should be verified or notarized. Such a certification may support a fraud judgment against the contractor, which may survive discharge in the event the contractor files for bankruptcy.

Additionally, if a lender is involved with the project, the owner might want to include language granting the lender approval rights as a condition precedent to payment. The existence of a surety also raises the possibility of additional payment conditions. First, the owner may want to allow itself the right, but not the obligation, to withhold payment to the contractor until the owner obtains the written consent to payment from the contractor's surety. Additionally, the contract should provide that if the contractor fails to complete the project by the completion date specified in the contract, the owner may withhold payment pending receipt of consent of the contractor's surety. Finally, the owner may want to reserve itself the right to withhold payment in the event the surety becomes insolvent or has its right to do business suspended, until the contractor supplies a good and sufficient bond or other security acceptable to the owner, in lieu of the bond originally provided.

Without expressly conditioning payment as set forth above, a contractor might argue that it is entitled to payment, without providing the owner the supporting documentation, which it reasonably needs to protect itself against improper, premature, or over payment. Addressing lien releases is especially important, because ultimately, the burden is on the owner to ascertain that all potential lienors against its property have been paid. For example, owners who fail to secure lien releases before paying general contractors may be held liable to subcontractors or suppliers who the general contractor failed to pay. Similarly, owners who fail to protect against the liens or claims of unpaid subcontractors or suppliers may find themselves in default of their construction loan covenants.

Finally, the contract should state that the architect's certification of a pay application and the owner's payment thereof should not be considered acceptance of work that is not in accordance with contract documents. The contract should also state that the mere use of the project improvements does not entitle the contractor to payment, nor does it waive the owner's right to demand strict compliance with the terms of the contract and conditions precedent to payment. **Retainage**

An owner's right to withhold "retainage," that is, a certain percentage of each progress payment, is a commonly accepted practice in the construction industry. Retainage protects an owner from contractor default while the project is underway and provides incentive to the contractor to timely complete the job because the owner has a right to hold some or all of the retainage until satisfactory completion of performance.

Typical retainage amounts are five to 10 percent of the earned contract price, although the amount withheld and the timing of the release of same may vary by contract. Another common approach is to withhold 10 percent retainage at the beginning of the project and once the project is 50 percent or more complete, to either withhold an agreed upon sum, usually not less than five percent, as to future earned amounts, or suspend any further withholding. Rather than releasing the retainage at substantial completion, the owner may want to reserve the right to withhold at least some retainage until the contract is fully completed and the project formally accepted by the owner. Alternatively, the contract may provide that upon substantial completion, the owner may at its option, reduce the retainage to an amount equivalent to a certain multiple of the value of the work determined by the architect or owner to be incomplete or defective. The AIA, AGC, and EJCDC forms include provisions for allowing an owner to withhold a certain percentage from each progress payment. Each of these forms allows the parties to determine the specific percentage amount to be withheld. In any contract allowing for reduced retainage for later progress payments, an owner should consider including contract language allowing full retainage reinstatement if the contractor defaults or if the owner is otherwise unsatisfied with the contractor's performance.

Because retainage is intended to protect an owner and ensure that the contractor will satisfy all of its legal and contractual obligations to the owner, including timely project completion, an owner should

always expressly reserve the right to withhold retainage in the construction contract. Withholding retainage without such an express reservation of right in the contract may be deemed a breach of the contract by the owner.

Reasons To Withhold Payment

Because an owner's unexcused failure to pay a contractor almost always constitutes a material breach, it is imperative that the contract explicitly entitle the owner to withhold payment as a proper response to the contractor's failure to properly perform its obligations to the owner.

The AIA, EJCDC, and AGC forms provide various reasons an owner may withhold payment, including: (1) defective work; (2) third party claims; (3) failure of the contractor to pay its subcontractors; (4) damage to the owner; (5) failure to carry out the work in accordance with the contract documents; or (6) reasonable evidence that the work cannot be completed within the contract time or for the remaining unpaid contract balance. Because disputes frequently occur over payment retention, it is crucial for an owner to have: (1) objective contract provisions entitling it to withhold payment; and (2) appropriate documentation and/or designer certification entitling it to withhold amounts it would otherwise have to disburse. **The Impact of Prompt Payment Legislation on the Owner's Right to Withhold Progress and Retainage Payments**

An owner's interest in withholding payment of progress payments and retainage to insure contract compliance and timely project completion must be balanced by the need of a contractor for just and timely compensation for its performance. The perceived propensity of some owners, whether intentionally or as the result of poor management, to delay payment for work performed longer than is necessary or reasonable has resulted in the enactment of federal prompt payment legislation.

Introduction to Prompt Pay Legislation

Complaints of slow payment by the federal government provided the impetus for a 1978 General Accounting Office study, which found that the federal government frequently did not justly and timely compensate its contractors. In fact, the problem was so endemic that, in many instances, contractors were forced to secure extra financing at higher interest rates to compensate for the nearly inevitable payment delays.

Ultimately, Congress passed the federal Prompt Payment Act – 31 U.S.C. § 3901 *et seq.* Congress's stated intent in passing this Act was to "accomplish what administrative rules and regulations had failed to do – provide incentives for the federal government to pay its bills on time." The main "incentive" to pay these bills on time is an interest penalty, which is typical of all prompt payment legislation. Generally, the federal government must pay a contractor within 30 days of a properly

submitted payment invoice, or interest will accrue until the contractor files a claim under the provisions of 41 U.S.C. § 7109 (formerly, these provisions were referred to collectively as the Contract Disputes Act of 1978).

The following summary discusses the provisions of the federal prompt payment laws and highlights the circumstances in which owners can legally withhold progress payments or contract balances.

The Federal Prompt Payment Act

The Prompt Payment Act (the “Act”) applies to contractors who have a direct contract with and who supply “property or services” to the federal government. The Act does not directly apply to subcontractors and other parties who are situated below the contractor on the contract chain. The Act provides that payment is due either on the date provided in the contract, or if no date is specified, 14 or 30 days after the relevant government agency receives a “proper invoice.” Whether the time period is 14 or 30 days depends on the type of payment the contractor requests.

The agency is deemed to have received a proper invoice either upon: (1) actual receipt; (2) seven days after the property is delivered or the services are rendered (i.e. “constructive acceptance”); or (3) “actual acceptance” of the property or services, whichever is later. There is, however, an exception where the contract specifies a longer acceptance period, when such a period is required to test or inspect the property or services to ensure contract compliance. In that situation, the seven-day constructive acceptance provision does not apply, and the invoice is deemed received upon actual acceptance.

If the proper payment invoice pertains to a progress payment, a 14-day penalty clock begins to run once the relevant agency receives the invoice – i.e., the agency has 14 days to pay the contractor before interest begins to accrue. By contrast, if the proper payment invoice pertains to a final contract payment or a retainage payment, a 30-day penalty clock begins to run once the relevant agency receives the invoice. If the agency does not pay within the applicable time period, interest begins to accrue and continues to accrue for up to a year or until the contractor files a claim under 41 U.S.C. § 7109, whichever is earlier. If the penalty applies, the agency is automatically required to pay the underlying debt and the penalty – the contractor does not have to make any separate demand for the interest. If the interest penalty goes unpaid, the contractor may file a claim pursuant to U.S.C. § 71 (41 U.S.C. § 7103) to recover the amount owed.

The above assumes a proper invoice, but the invoice might be deficient in some respect. The Act requires that the contracting agency review invoices “as soon as practicable . . . for the purpose of determining that such an invoice is a proper invoice.” Invoices must include: (1) the amount requested, including facts substantiating that the amount is correct and complies with the contract’s terms; and (2) a certification that the contractor (i) paid the subcontractors and suppliers their shares

from previous payments, (ii) will timely pay the subcontractors and suppliers their share of the requested payment, and (iii) did not request any money the contractor plans to withhold from the subcontractors and suppliers.

The agency must return an improper invoice within seven days. If the agency fails to do so, each day past the seventh day reduces the interest penalty clock. Moreover, the agency must specify why the invoice is deficient. Upon return, the contractor has the opportunity to cure the defect and return a proper invoice, beginning the process anew.

Assuming that the request was proper from the outset, or that all deficiencies are eventually corrected, the interest penalty clock begins to run. If the government pays on time, no interest will accrue. But, if the government pays late, the interest will accrue as mentioned above.

The Act imposes several obligations on contractors as to payments to their subcontractors and suppliers. First, they must include the following in their subcontractor and supplier contracts: (1) a provision that the contractor must pay its subcontractors and suppliers within seven days after the government agency pays the contractor for property or services supplied by the subcontractor or supplier; (2) a penalty clause that requires the contractor to pay interest on amounts that the contractor failed to pay as required by (1); and (3) a provision that the subcontractors and suppliers must include similar payment and interest penalty clauses in their contracts with sub-subcontractors and suppliers.

Second, the contractor is responsible for ensuring its subcontractors' and suppliers' compliance with the Act. Third, the Act permits contractors to withhold retainage from their subcontractors and suppliers provided that their subcontracts contemplate this and the contractor notifies the appropriate agency's contracting officer, informing the officer that the contractor is withholding subcontractor or supplier retainage. If the contractor withholds retainage, it cannot request that the government release those funds until the subcontractor has satisfactorily completed the required work and the contractor intends to disburse the retained funds – *i.e.*, the government retains these funds, not the contractor.

Finally, although the Act's imposition of an interest penalty against the public agency owner only flows to contractors, the subcontractors and suppliers do possess limited rights as to the public agency. Specifically, the subcontractors and suppliers may request information from the relevant agency to ensure that the contractor has been timely paying them, upon receipt of payments from the agency. These informational rights also allow the subcontractors and suppliers to request and obtain information about the contractor's payment and performance bonds.

Contractual Self-Help Remedies

To further protect itself against loss resulting from a defaulting contractor's claim of entitlement to payment, an owner could consider including contract language entitling it to exercise certain "self-help" remedies, such as cross-default clauses, joint payment checks, and set-off rights. A cross-default clause provides that a contractor defaults on every contract with the owner if the contractor defaults on any one of its contracts with the owner. A typical cross default clause may provide:

Notwithstanding anything herein to the contrary, owner shall be entitled to withhold from any amount due contractor hereunder any sums which may be owed owner by contractor either under this contract or any other contract between owner and contractor. Further, at owner's sole election, any default by contractor under this contract shall be deemed a default by contractor under any other agreement between the parties and a default by contractor under any other agreement it has with owner shall be deemed a default by contractor under this contract.

The problem with such a provision in a negotiated contract (as opposed to a contract on a public project with no right of the bidders to try to vary the bid documents by negotiation) is the risk that the contractor may want to modify it to make it reciprocal. Such a circumstance might increase the contractor's bargaining leverage by allowing it to argue it is entitled to back out of every project it is working on for the owner because of a payment dispute on only one project.

Joint checks are another common remedy an owner might use to avoid or mitigate the impact from a contractor dispute, although some jurisdictions may not allow the owner to issue joint checks. Joint checks reduce the risk of mechanics liens due to the contractor's failure to pay its subcontractors or suppliers. An owner might also require this arrangement if it has never done business with the contractor or if the contractor becomes financially unstable during the project. An owner's biggest risk in issuing joint checks is its potential liability to third-parties, such as subcontractors or suppliers, in the event the owner promises to issue joint checks and subsequently fails to do so. An owner should also include a set-off provision in its construction contract, allowing it to set off against payments otherwise due the contractor any amounts the contractor owes to owner, including any damages or expenses the owner incurs when a contractor defaults. A set-off could occur when a contractor defaults under its contract, as the default would permit the owner to use retainage to complete the contract, including satisfying the contractor's payment obligations to its lower tier subcontractors and suppliers.

Alternative Security

Owners have other avenues to reduce the risk a contractor will not properly complete a construction project. At the outset of a project, an owner may require one or more of a variety of contractual assurances including traditional payment and performance bonds, warranty or maintenance bonds, guaranties, letters of credit, and collateral security.

Payment and performance bonds are the typical means of securing a contractor's obligations. Such bonds protect an owner against loss due to the contractor's inability or refusal to perform its contract obligations, including the contractor's default of its payment obligations to lower tier subcontractors or suppliers. The AIA, EJCDC, and AGC forms have specific provisions addressing whether a project requires a bond. Because performance and payment bonds can add significant cost to an otherwise tight budget, an owner might want to consider alternative types of security.

Another security option is to require that the contractor provide a warranty or maintenance bond. As its title indicates, a warranty or maintenance bond is intended to cover the contractor's maintenance and warranty obligations – obligations that sometimes do not arise until post-payment. Performance bond coverage is restricted to an individual bond's express terms. Although the performance bond might logically include warranty obligations, a court may conclude that a performance bond merely serves as a completion guarantee. Consequently, if an owner desires warranty coverage as well, it may want to ensure that the relevant bond's language extends post-completion and includes the contractor's maintenance and warranty obligations.

In lieu of a bond, the owner might consider requiring the contractor to provide a letter of credit ("LOC"). There are many types of LOCs. "Standby" LOCs are the type most often used to guarantee a contractor's performance. These instruments obligate the issuer (usually a bank) to pay the project owner (referred to as the obligee or beneficiary), upon demand by the owner, all or a portion of the LOC amount if the contractor defaults. As security, the issuer of the LOC will generally require the contractor to maintain a certain amount of liquid assets on account with the issuer. Before paying on a LOC, the issuer requires that the project owner present documentation, as required by the LOC, indicating the contractor has defaulted.

Another security alternative is for an owner to require the contractor to provide a third-party guaranty. Similar to the various types of alternative security discussed above, guarantees ensure that a third-party steps in and guarantees the contractor's obligations if the contractor defaults. Guarantees are often used where the contractor is a subsidiary and the guarantor is the parent company. Additionally, an owner could require an individual's personal guaranty, usually the contractor's principal, if the owner suspects the contractor is a shell entity with no real assets.

Finally, if a contractor needs a release of retainage to insure payment of its subcontractors at some point in the latter stages of a project, but the owner has lingering concerns over a contractor's ability to perform or make payment, it may want to take advantage of a contractual right to require substitute security in exchange for a release of some or all of the retainage.

Summary

In conclusion, to protect itself as much as possible, an owner should include the following in its

construction contracts: (1) specific, detailed conditions precedent, with which a contractor must comply before it is entitled to payment; (2) specific and express retainage terms; (3) self-help remedies; and (4) alternative security provisions. Manifestly, the contract should accommodate the requirements of the applicable prompt payment statutes, and, to the extent possible, affirmatively negate any statutory provisions that disadvantage the owner.

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