

I. INTRODUCTION

In any contractual venture, each party has a legitimate interest and responsibility in ascertaining whether the other party is fully capable of performing all of its contractual obligations. Too often the Contractor does not have this information --- either because the Contractor fails to ask for it, is reluctant to ask, or the Owner refuses to provide the information.

The 1997 edition of the American Institute of Architects (“AIA”) A201 General Conditions (Section 2.2.1) provides that a Contractor has the right, both prior to executing the contract and at any time thereafter, to require the Owner to furnish “reasonable evidence that financial arrangements have been made to fulfill the Owner’s obligations under the Contract.”

II. STEPS TO ENSURE A FINANCIALLY TROUBLE FREE JOB

- A. Have a signed contract before commencing work. This is simple and sound advice that is nevertheless often overlooked.
- B. Require that the contract provide for the Owner’s compliance with a request for financial information (important if A201 is not being used).
- C. Identify the Owner of the property on which the project is being constructed, as well as the contracting party. Is the construction financing secured by the land?
- D. If using the Owner’s contract form, get a legal review of the document. The expense is cost effective in the long run.
- E. Even if an AIA or AGC contract form is being used, review carefully to be sure standard provisions have not been modified.
- F. Insist on contractual provisions that you feel are fair and essential. Do not be afraid to suggest an alternate contract form. AGC and AIA both have excellent contract documents which enjoy industry-wide acceptance.
- G. Obtain a copy of the Owner’s financial statement --- preferably certified by a CPA. If available, obtain a “D & B” from Dunn & Bradstreet. This can provide substantial financial data and other information on the Owner’s operations.
- H. Obtain a credit report on the Owner --- a bank can assist in this effort. Also, publicly held companies issue annual reports.
- I. Obtain a copy of the Owner’s construction loan agreements for construction and permanent financing. Copies of the loan documents are preferable over a simple commitment letter because the loan documents will include all of the lender conditions and requirements. Of significance are the requirements for notification to the lender and whether the lender must approve changes.
- J. Be aware of a loan commitment which covers items other than

construction.

K. Request a lender's "set aside" letter which acknowledges the portion of construction loan proceeds available exclusively for payment of construction draws.

L. Identify whether there are sufficient funds available not only for the original contract amount, but also for contingencies, such as changes and extras. If there is not money set aside at the outset for contingencies, as changes or extras arise, the Contractor must make a separate request for financial information pertaining to the change. There should be a procedure established for notifying the lender of changes.

M. Determine the source of funds, the method and time of disbursement and the persons through which the funds must pass before reaching the Contractor.

N. Investigate the stability of the lender. (Periodic meetings with the lender during construction to review project status are also valuable.)

O. Determine the legal structure of the Owner. If a corporation, determine who is authorized to sign on behalf of the corporation by requiring a corporate resolution. If a partnership, determine who are the general partners and which partners can legally bind the partnership.

P. Request a list of the Owner's prior projects. Investigate the Owner's payment performance on previous projects.

Q. Do not ignore the project architect. What role does the architect play in the payment process? Investigate the architect's reputation relative to expeditious contract administration, particularly regarding processing payment requests.

R. Ask for a copy of the Owner's agreement with the architect. This will assist in assessing whether sufficient funds are available to cover the Owner's financial obligations, particularly if loan proceeds can be used to pay design costs. It will also identify the architect's contract administration responsibilities and whether his responsibilities are consistent with the provisions of A201, if it is being used. In addition, the Owner/architect agreement will help determine whether the architect has insurance. The latter point is important because it could materially affect the Owner's financial capabilities if claims are ever filed because of design errors and the architect is uninsured.

S. Check the applicable lien statutes relative to the Contractor's rights and those of subcontractors and suppliers and the procedures to enforce those rights. Do this at the outset of the project. Pay particular attention to the Contractor's standing relative to the construction lender. If A201 is being used, Section 2.2.1 also gives the Contractor the specific right to this information.

T. Obtain information regarding the Owner's property insurance coverage. Be aware of the policy provisions regarding deductibles and contract clauses requiring waiver of subrogation.

U. If some portion of the funds is being provided by a governmental entity, determine the nature of the funding program; whether a loan, a grant, or a bond issue; the name of the grantee if a grant or the bond trustee if a bond issue; the name and address of the agency contact person; and, the expiration date of the grant, if applicable.

III. SOURCES OF INFORMATION

- A. Contractor's Bank
- B. Contractor's Bonding Company
- C. Owner Financial Questionnaire - AGC Document No. 690
 - 1. Project Owner - Identity of Owner and its legal structure.
Identify authorized signers.
 - 2. Land Information - Identify whether the contracting Owner holds legal title to the project property.
 - 3. Financing Information - Sources of Project Financing.
 - 4. Copies of Relevant Documents
 - a. Owner's Certified Financial Statement - Make every attempt to get a financial statement certified by a CPA.
 - b. Construction Loan Agreement - This has been explained above.
 - c. Lender's "Set-Aside" Letter - Explained above.
 - d. Owner/Architect Agreement
 - e. Owner's Property Insurance and/or Builder's Risk Policy
 - f. Architect's Professional Liability Policy

IV. SUBCONTRACT PAYMENT CLAUSES

- A. Four criteria for good payment clauses;
 - 1. Clear statement of entitlement to payment in full upon Subcontractor's satisfactory completion of work;
 - 2. Limitation of retainage on progress payments to the rate actually being retained by Owner for Subcontractor's work;
 - 3. Prompt pass-thru of Subcontractor's share of payments received

from the Owner, including payments for stored materials; and

4. A statement that Subcontractor is to receive payments to which he is entitled within a specified or reasonable period if the prime Contractor has not been paid for any reason which is not Subcontractor's fault.

B. Suggested modifications (Recommended by the American Subcontractors Association)

No Unreasonable Delay. "Notwithstanding the foregoing provisions of this contract, payments to the Subcontractor shall not be unreasonably delayed in the event payments to Contractor, under its general contract, are delayed, to the extent the reasons for such delay are unrelated to Subcontractor's performance hereunder."

Right To Deal With Owner. "In the event the Owner fails to pay the amount certified to be due Subcontractor, or to pay the Subcontractor directly, Contractor does hereby appoint Subcontractor as his attorney in fact and in his name, or in Subcontractor's name, as Contractor's authorized agent, to take any action against the Owner Subcontractor deems appropriate to procure payment, including any penalties, costs and claims connected thereto, following a period of sixty days after the work for which payment is delinquent has been performed."

IV. STATUTORY REMEDIES FOR PAYMENT

A. Pennsylvania Mechanics' Lien Law, 49 P.S. §§1101-1902

1. Definition. A mechanics' lien is a statutory security for enforcing payment of debts due for labor or materials furnished in the erection, construction, alteration or repair of an improvement to real estate.
2. Cumulative Remedy. It is a cumulative remedy and does not derogate other available remedies such as an action in assumpsit on a construction contract or payment bond.
3. Lien is Available to Prime Contractors and Subcontractors. The lien is available to a prime Contractor (i.e., one who contracts directly with an Owner) and to a Subcontractor (i.e., one who contracts with a prime Contractor). It is not available to one who is below the level of Subcontractor in the contractual chain, such as a supplier of a Subcontractor.
4. Material Suppliers. One who does nothing more than supply or haul materials or equipment which are reasonably necessary for and actually used in connection with the erection, construction, alteration or repair of an improvement may nonetheless be a "Contractor" or a "Subcontractor" under the Mechanics' Lien Law. There is a presumption that materials furnished for use in or upon an improvement placed on or near the property or delivered to the Owner pursuant to a contract were used in the

improvement. However, if the supplier retains title or a security interest in the materials or equipment under the Uniform Commercial Code or otherwise, a mechanics' lien is not allowed to the extent of such security interest. The claimant may have a security interest or mechanics' lien but not both.

5. Architects or Engineers. An architect or engineer who performs only design services or who contracts with someone other than an Owner is not entitled to a lien. An architect or engineer may be entitled to a mechanics' lien if he/she performs supervisory services for an Owner.

B. Payment Bond Claim --- Public Works Projects And Certain Private Contracts Projects

1. Pennsylvania

a. Although 49 P.S. § 1303 (b) provides that a Contractor may not file a lien against a public works construction project, a Subcontractor is not left without some form of protection. The Public Works Contractors Bond Act, 8 P.S. § 191, et seq., requires that before the award of any Commonwealth or any public unit or agency, the prime Contractor must furnish a payment bond at 100% of the contract amount.

b. This represents a decision by the legislature that subcontractors on public work projects shall be protected, but not at the expense of encumbering state or local government property. Section 193 (a) (2) provides that the required payment bond shall be "...solely for the protection of claimants supplying labor or material to the prime Contractor to whom the contract was awarded, or to any of his subcontractors..."

c. Notice Requirements --- A sub-subcontractor (as opposed to a claimant who had a direct relationship with the prime Contractor) may bring an action on a payment bond only if he has given written notice setting forth specific of that claim within 90 days after that claimant last performed work or furnished materials. The notice must be by registered or certified mail or by personal service in the manner of service of a summons.

d. Limitations --- Unless modified by the terms of the bond, any action upon a payment bond must be commenced not prior to 90 days and not later than one year after the claimant last performed work or furnished materials.

e. Payment Bonds on Private Projects --- Although there is no statutory requirement that such protection be provided, private owners sometimes require the general Contractor to obtain a payment bond running to subcontractors. This can be helpful in inducing the contractors to waive their rights to file a lien claim.

2. Federal Projects --- The Miller Act

a. The Miller Act is the federal counterpart to the Pennsylvania Public Works Contractors Bond Act. It is codified at 40 U.S.C.A. §270, et seq., and applies to federal construction projects exceeding \$100,000.00.

b. Extent of protection --- The Miller act permits suits on a payment bond by first-tier subcontractors and materialmen and by subcontractors and materialmen having a contractual relationship with a first-tier Subcontractor. The right of action does not run to anyone more remote than a second tier Subcontractor.

c. Notice Requirements --- Any claimants other than first tier subcontractors or materialmen must give notice of a claim to the general Contractor within 90 days of the date when a labor or material was last furnished. Service must be by registered or certified mail, or by United States Marshall.

d. The Limitations --- Suit under the Miller Act must be commenced within one year after the date on which labor or material were last furnished. Note that this differs from the time within which the 90-day notice must be given, which relates to the last day labor or materials were furnished by the Subcontractor giving that notice.

C. Pennsylvania Contractor and Subcontractor Payment Act, 73 P.S. §§501-516

1. Purpose, Applicability And Effective Date. The purpose of the Act is straightforward --- to require that contractors, subcontractors and suppliers furnishing labor and material for construction be paid promptly for such labor or material, and to minimize the ability for higher tier participants --- beginning with the Owner --- to hold back funds. The Act applies to virtually all construction except “improvements to real property which consist of six or fewer residential units which are under construction simultaneously.”

2. The Act’s Payment Provisions. At the outset, any discussion of the Act must be within the context of the caveat that because the Act is new, there is some uncertainty how courts will actually interpret it. While this caveat is appropriate with respect to most new laws, it is especially appropriate here --- the Act is silent as to many important issues and contains more than an expected number of vague provisions. Certain of these are noted in the discussion that follows.

3. Payment --- Owner To Contractor

a. Owner Defined. The Act defines an Owner as a person that has an interest in the real property being improved and who ordered the improvement to be made, and includes the Owner’s successors and agents acting within their authority. The Act is silent with respect to whether a tenant is an Owner, but inasmuch as a tenant has at least a leasehold interest in the property, there is at least a viable inference that a tenant may be an “Owner” for purposes of the Act.

b. Contractor Defined. A “Contractor” under the Act is any entity authorized or engaged by an Owner to improve real property.

c. Payment Provisions. The payment provisions as between an Owner and Contractor start simply enough, but then become problematic. Section 4 of the Act, 73 Pa. Stat. Ann. §504, provides simply that:

“Performance by a Contractor or a Subcontractor in accordance with the provisions of a contract shall entitle the Contractor or Subcontractor to payment from the party with whom the Contractor or Subcontractor has contracted.”

Section 5(a) of the Act, 73 Pa. Stat. Ann. 505(a) provides that “[T]he Owner shall pay the Contractor strictly in accordance with the terms of the construction contract.” The Act seems to reinforce this seemingly simple concept by making the “Time for Payment” provision of §505(c) and “Interest” provision of §505(d) subject to the provision appearing in each of those subsections “Except as otherwise agreed by the parties...,” suggesting that the parties may contract around the requirements of the Act. As will become clear, because of other provisions that do not contain this “[E]xcept as agreed...” language, whether this is actually the case is unclear.

d. Timing of Payment. Subsection 505(c) provides that, “[E]xcept as otherwise agreed by the parties”, payment of interim and final invoices shall be due from the Owner 20 days after the end of a billing period or 20 days after delivery of the invoice, whichever is later. “Delivery” is defined in the Act as including, but not limited to, first class or registered mail, hand delivery or transmission by fax. Mail properly addressed is deemed to be delivered three days after the date it is sent. In the absence of a payment term in the contract, §505(b) provides that the Contractor shall be entitled to submit an interim invoice at the end of the calendar month within which work was performed, and a final invoice for payment in full upon completion of the work.

e. Withholding of Payment. Section 506 provides that the Owner may withhold payment to the Contractor according to the terms of the construction contract for any “deficiency items,” which are defined in the Act as:

“work performed, but which the Owner, the Contractor or inspector will not certify as being completed according to the specifications of a construction contract.” §502.

To withhold payment, the Owner must notify the Contractor of the deficiency item within seven calendar days of the date that the invoice is received, and the Owner may withhold payment only for that portion of the invoice representing the deficiency item. Section 506 does not contain the “[E]xcept as otherwise agreed...” language that appears in §§505(c) and (d), and the Act is silent as to what happens if there exists a valid deficiency item, but notice is not provided within the seven day period specified. The Act is also silent as to whether payment may be withheld for defective or improper work where a contract contains no specifications.

Where an invoice is incorrect, improper or incomplete, the entity

receiving it has ten working days to provide written notice of the problem under §508(a). Section 508(b) requires that the entity receiving the invoice pay the “amount actually incurred on the due date in accordance with the provisions of this act.”

4. Payment --- Contractor To Subcontractor

a. Subcontractor Defined. The Act defines a “Subcontractor” as to any entity who has contracted to furnish labor or materials to, or has provided labor for, a Contractor or another Subcontractor in connection with a contract to improve real property; the term “Subcontractor” appears encompass suppliers. It is in the areas of payments between contractors and subcontractors as well as between subcontractors and other subcontractors that the Act’s full impact becomes apparent.

b. Payment Provisions. The payment provisions with respect to subcontractors start out in the same manner as those to contractors. Section 507(a) provides:

“Performance by a Subcontractor in accordance with the provisions of the contract shall entitle the Subcontractor to payment from the party with whom the Subcontractor has contracted.”

Note that this section lacks the “pay-when-paid” language commonly contained in subcontracts, nor does it contain other traditional prerequisites to entitlement to payment. Also important to note is the fact that §507 --- entitled “Contractor’s and Subcontractor’s Payment Obligations” --- does not contain the “Except as otherwise agreed by the parties...” language that appears in §505 as between the Owner and Contractor. At a minimum, this raises a question whether subcontractors may waive or, in practical terms, be forced to waive) the requirements of the Act, and further raises an issue as to the effect of any incorporation by reference or “flow down” clause in which a subcontract incorporates the terms of the Owner’s contract with the Contractor; until the Pennsylvania Supreme Court rules on these issues, this uncertainty will continue.

c. The Built-In “Pay-When-Paid” Clause and How it May be Lost. Section 507(c) provides that when a Subcontractor has performed in accordance with the provisions of the contract, a Contractor shall pay the Subcontractor and each Subcontractor shall in turn pay to the Subcontractor’s subcontractors

“the full or proportional amount received for each such Subcontractor’s work and materials, based on work completed or services provided under the subcontract, 14 days after receipt of each progress or final payment or 14 days after receipt of the Subcontractor’s invoice, whichever is later.” [emphases added]

Although this suggests that the law builds in a “pay-when-paid” concept, §507 also contains one of the Act’s biggest traps --- §507(b) requires that a Contractor or Subcontractor shall disclose to a Subcontractor, before a Subcontract is executed, the due date for receipt of payments from the Owner. That subsection goes on to provide:

“Notwithstanding any other provision this act, if a Contractor or Subcontractor fails to accurately disclose the due date to a Subcontractor, the Contractor or Subcontractor shall be obligated to pay the Subcontractor as though the due dates established in

§505(c) were met by the Owner.

The effect of this section appears to be that failure to disclose to a lower tier Subcontractor or supplier, prior to execution of a contract, the dates upon which payment is due from the Owner will create an obligation to make payment as if the Owner had complied with the Owner's payment obligations, whether or not the Owner actually made payment. Based on this, if you are participating on a project as a Contractor or Subcontractor you should be certain that your company makes the required disclosures before execution of a subcontract flowing down the chain of privity so as to preserve the "pay-when-paid" provisions built into the Act.

d. Withholding of Payment. §507(c) provides that payment to a Subcontractor shall be made under §507 unless the payment is being withheld under §511. §511 provides that a Contractor or Subcontractor may withhold payment from any Subcontractor responsible for a "deficiency item" as discussed above, but shall pay "according to the provisions of this act for any item which appears on the invoice and has been satisfactory completed." Because §507(c) provides that a Subcontractor shall be paid "unless" payment is being withheld under §511 (which speaks only in terms of deficiency items), there will certainly be litigation as to whether a "deficiency item" is the only basis for withholding from a Subcontractor. If it is, the law is inconsistent with industry practice and the standard contract forms of the American Institute of Architects and Associated General Contractors of America which provide for withholding payment for a variety of reasons that may not fit within the definition of a "deficiency item," such as delay, failure to pay subcontractors, failure to furnish a bond or insurance certificates.

e. Notice of Deficiency. Another significant trap in the Act -- and a further departure from present practice, including that embodied within the AIA and AGC forms --- is the requirement under §511(b) that if a Contractor or Subcontractor withholds payment from a Subcontractor for a deficiency item, the Contractor or Subcontractor must notify the Subcontractor or Supplier and the Owner of the reason "within 7 calendar days of the date after receipt of the notice of the deficiency item." In addition to the fact that a 7-calendar-day period may be unrealistically short turnaround given the way business is presently conducted, the Act is silent as to what is meant by "notice of the deficiency item". This is another item that will have to be clarified with litigation. As with the failure of an Owner to give notice of a deficiency item to a Contractor within 7 days of receipt of an invoice, the Act is silent as to what happens if the required notice is not provided to a Subcontractor within the seven-day period.

5. Retainage

§509(a) provides that "if payments under a construction contract are subject to retainage," any amounts retained and which are due to be released to the Contractor upon final completion shall be paid within 30 days from acceptance of the work. Unlike the provisions for interim payments, the Act does not provide that this is "[E]xcept as otherwise agreed by the parties ...", and whether it is will be subject to argument and judicial interpretation. Another inconsistency is that while the

Act does not provide the “[E]xcept as otherwise agreed by the parties...” language with respect to interim payments to subcontractors, §509(b) provides that if an Owner is not withholding retainage, a Contractor may withhold retainage from a Subcontractor “in accordance with their agreement.” That subsection goes on to provide, however, that retainage shall be paid within 30 days after final acceptance of the work, casting at least some doubt upon provisions in “their agreement”, which are not uncommon, setting a different time for the payment of retainage. Moreover, the Act silent as to from whom such “final acceptance” must come, and there is a world of difference if such acceptance is by a Contractor rather than an Owner.

§509(c) provides that contractors and subcontractors shall pay to lower tier subcontractors the full amount due within 14 days after receipt of retainage.

6. Consequences Of Non-Compliance

a. Interest. Unlike some legislation, this Act has “teeth.” Failure by an Owner, Contractor or Subcontractor to make payment when due will subject that party to liability for interest at the rate of 1% per month on the balance then due and owing. This interest rate is also applicable to an unreasonable withholding of acceptance of work.

b. Penalty and Attorneys Fees. In addition, if arbitration or litigation is commenced to recover payment due under the Act and it is determined that an Owner, Contractor Subcontractor has failed to comply with payment terms, then the arbitrator or court is required to award an additional penalty of 1% per month of the amount that was “wrongfully withheld” as well as reasonable attorneys’ fees and expenses. Thus, while some uncertainty exists, it appears that a non-complying party will be subject to interest at a rate of 24% per year plus attorneys’ fees and costs of court litigation or arbitration.

7. Requirement That Pennsylvania Law Apply

§514 provides that making a contract subject to the laws of another state or requiring that any litigation, arbitration or other dispute resolution process on the contract occur in another state, shall be unenforceable. While this is clearly an attempt to frustrate any effort to draft around the Act, there are very real questions as to whether this provision is constitutional.

8. Third Party Claims

§516 appears intended to provide some comfort, at least to contractors. That Section provides:

“Once a Contractor has made payment to the Subcontractor according to the payment terms of the construction contract or the provisions of this act, future claims for payment against the Contractor by parties owed payment from the Subcontractor which has been paid shall be barred.”

This is another example of problems with the language of the Act. Because both “Contractor” and “Subcontractor” are defined terms, does §516 as written limit this protection to contractors, or does it apply to a Subcontractor that makes full payment to

a lower-tier Subcontractor? Again, this will likely be determined as court decisions shape the parameters as how this Act will actually work. Other questions that will have to be resolved is the interrelationship between the Act and the Pennsylvania Mechanics' Lien Law and the effect that §516 will have on payment bond claims.

D. Commonwealth Procurement Code, 62 Pa. C.S.A. §§3931-3939

1. Introduction

On December 19, 1994, Governor Casey signed legislation amending the Commonwealth Procurement Code so that the payment requirements under that Act are, in many instances, similar to those of the Pennsylvania Contractor and Subcontractor Payment Act which became effective earlier during 1994.

Just as was the case with the Contractor and Subcontractor Payment Act, these amendments to the Commonwealth Procurement Code (sometimes referred to in this summary as the "Amendments"), **changed prevailing payment practices** for certain public construction work in Pennsylvania, in some cases displacing practices that have been prevalent for decades, and in others, going so far as to displace agreements entered by contracting parties.

2. Applicability And Effective Date

The provisions apply to contracts exceeding \$50,000.00 for construction, reconstruction, alteration or repair of any public building, public work or improvement where the contracting body is the Commonwealth of Pennsylvania or any state-aided institution, or any political subdivision, local governmental unit, local authority or other incorporated district or public instrumentality which has authority to enter into a public contract; in the Amendments these are referred to as "contracting bodies." Stated alternatively, the provisions of the Act apply to most governmental construction in Pennsylvania where the prime contract exceeds \$50,000.00. There are, however, significant exceptions.

Section 6.8(b) provides that Section 6.2 of the Amendments --- which sets payment deadlines for contracting bodies --- does not apply in certain situations where a contracting bodies - --- does not apply in certain situations where a contracting body's failure to pay is based on a lack of funding by the General Assembly or the state or federal government. Moreover, Section 6.8(c) provides that the Amendments do not apply to:

- a. The City of Philadelphia, "so long as any deficit reducing bonds issued pursuant to the Intergovernmental Cooperation Authority Act of 1991 are outstanding and payable";
- b. Any authority controlled by or related to the City of Philadelphia and to the Philadelphia School District;
- c. Certain municipalities determined to be "distressed;" under the "Municipalities Financial Recovery Act"; and
- d. School districts determined to be "distressed" under

the Pennsylvania School Code.

While there is room for differing interpretation, although the Amendments' payment requirements do not apply to these entities, it appears that such requirements will apply to subcontracts issued by contractors and subcontractors working pursuant to prime contracts with those entities. Thus, while the payment deadlines that the Amendments impose upon contracting bodies may not apply to the City of Philadelphia and certain other entities, once a prime Contractor receives payment under its prime contract with such entities, it appears that the deadlines imposed upon contractors and subcontractors for making payment will be applicable.

Because of these exceptions, and because all provisions of the Amendments may not apply to all public owners, one should not enter a contract on the assumption that the Amendments will or will not apply without previously determining whether that will be the case.

3. Payment Provisions

At the heart of the legislation are provisions similar --- but not identical to provisions in the Contract and Subcontractor Payment Act.

a. Payment --- Contracting Body to Contractor.

A Contractor is defined as a person who enters into a public contract which provides:

“Performance by a Contractor in accordance with the provisions of a contract shall entitle the Contractor to payment from the contracting body.”

Section 6.2 imposes payment deadlines on contracting bodies. Section 6.2(a) provides that “[T]he contracting body shall pay the Contractor strictly in accordance with the public contract.”

Section 6.2(b) provides that progress payments are due by the due date established in the contract, or in the absence of such date, 45 days after the Contractor submits a payment application. Under Sections 6.2(c) and (d), where payments are not made within the time required, the contracting body is required to pay interest at the rate determined by the Secretary of Revenue for payment of overdue taxes or tax refunds, but interest is not payable if payment is made within 15 days of the due date.

b. Payment --- Contractor to “Subcontractor”.

As with the Contractor and Subcontractor Payment Act, the term “Subcontractor” includes subcontracts of all lower tiers, and is defined as:

“a person who has contracted to furnish labor or materials to, or has performed labor for, a Contractor or another Subcontractor in connection with a public contract:

As is the case with the Contractor and Subcontractor Payment Act, it is in the areas of payments between contractors and

subcontractors, as well as between subcontractors and other subcontractors, that the Amendments' full impact becomes apparent.

The payment provisions with respect to subcontractors start out in the same manner as those to contractors. Section 6.1(b) provides:

“Performance by a Subcontractor in accordance with the provisions of the contract shall entitle the Subcontractor to payment from the party with whom the Subcontractor has contracted.”

Note that this section in and of itself does not contain the “pay-when-paid” language commonly contained in subcontracts, nor does it contain other traditional prerequisites to entitlement to payment, such as furnishing proof of payment of lower tiers.

c. The Built-In “Pay-When-Paid” Clause and How it May be Lost.

Section 6.3(a) provides that performance by a Subcontractor in accordance with the provisions of the contract shall entitle the Subcontractor to payment from the party with whom the Subcontractor has contracted AND that for purposes of the Amendments, the subcontract shall be presumed to incorporate the terms of the public contract.

Section 6.3(c) provides that when a Subcontractor has performed in accordance with the provisions of the contract, a Contractor shall pay the Subcontractor and each Subcontractor shall in turn pay to the Subcontractor's subcontractors:

“the full or proportional amount received for each such Subcontractor's work and materials, based on work completed or services provided under the subcontract, 14 days after receipt of a progress payment.” [emphasis added]

Thus, Section 6.3(c) requires the Contractor or Subcontractor to make payment only upon receipt of payment (i.e., when paid). However, the benefits of this provision can be lost.

Section 6.3(b) contains disclosure provisions similar to those in the Contractor and Subcontractor Payment Act that can require the Contractor or Subcontractor” to make payment irrespective of whether it has received payment, depending on whether the Contractor or Subcontractor has complied with those provisions. Specifically, Section 6.3(b) requires that a Contractor or Subcontractor shall disclose to a Subcontractor, before a subcontract is executed, the due date for receipt of progress payments from the contracting body. That subsection goes on to provide:

“Notwithstanding any other provision of this act, if a Contractor or Subcontractor fails to accurately disclose the due date to a Subcontractor, the Contractor or Subcontractor shall be obligated to pay the Subcontractor as though the due dates established in Subsection (c) where met by the contracting body.” [emphasis added]

The failure of Section 6.3(b) to specify which “subsection (c)” it is referring to may render that portion sufficiently ambiguous to be unenforceable, but one should not count on this; the likely effect of this section appears to be that failure to disclose to a lower tier Subcontractor or supplier, prior to execution of a contract, the date upon which payment is due from the contracting body will create an obligation to make payment as if the contracting body had complied with the contracting body will create an obligation to make payment as if the contracting body had complied with the contracting body’s payment obligations, whether or not the contracting body actually made payment.

Sections 6.3(d) and (e) provide that where payments are not made within the time required, the Contractor or Subcontractor is required to pay interest at the rate determined by the Secretary of Revenue for payment of overdue taxes or tax refunds, but interest is not payable if payment is made within 15 days of the due date.

4. Withholding of Payment

The Amendments contain the same ambiguity concerning withholding of payment that appears in the Contractor and Subcontractor Payment Act, and this is a result of the Amendments’ reliance on the concept of a “deficiency item”. In Section 1 of the Amendments, a deficiency item is defined as:

“Work performed but which the design professional or the Contractor or the inspector will not certify as being completed according to the public contract...”

Section 6.4 provides that payment may be withheld for a deficiency item, but the party so withholding shall pay according to the provisions of the Amendments for all other items which appear on the application for payment and appear to have been satisfactorily completed. Because Section 6.3(d) provides that a Subcontractor shall be paid “unless” payment is being withheld under Section 6.4 (which speaks only in terms of deficiency items), there will certainly be litigation as to whether a “deficiency item” is the only basis for withholding from a Subcontractor. If it is, the Amendments are inconsistent with industry practice and the standard contract forms of the American Institute of Architects and Associated General Contractors of America which provide a variety of reasons for withholding payment to mitigate risks such as a Subcontractor’s failure to make payments, or potential claims by other parties that may not fit within the definition of a “deficiency item.”

If a contracting body or higher-tier Contractor or Subcontractor withholds payment for a deficiency item, Section 6.4(b) requires that notice be given of such withholding. A contracting body is required to provide such notice within the time set forth in the contract or within 15 days after receipt of a payment application, and a Contractor or Subcontractor is required to provide notice to the next lower tier within 15 days after receiving notice of the withholding. NOTE: This is a longer period than the seven-day period specified in the Contractor and Subcontractor Payment Act --- if you perform both public and private work, you should not confuse the two periods and assume that the longer period applicable to public work will protect you on non-public work.

5. Consequences Of Non-Compliances

Section 6.5 provides that if an action is commenced to recover payment --- whether for a progress payment under the Amendments or for retainage as set forth in the original Act, and whether such action is in court, by way of arbitration, or a claim with the Board of Claims --- and it is determined that a contracting body, Contractor or Subcontractor failed to comply terms of the Amendments, the arbitrator, Board of Claims or court may award, in addition to all other damages due, a penalty equal to 1% per month of the amount that was “withheld in bad faith”. Section 6.5(a) goes on to provide:

“An amount shall be deemed to have been withheld in bad faith to the extent that the withholding was arbitrary or vexatious. An amount shall not be deemed to have been withheld in bad faith to the extent it was withheld pursuant to Section 6.4.”

Although the Amendments are silent as to whether a tribunal should award a penalty in situations there there was a good faith reason for withholding payment, but that reason did not fit within the pigeonhole definition of “deficiency item”, we believe the Amendments can be reasonably construed to provide the tribunal with discretion to refrain from awarding a penalty in such situations. Whether that will happen, however, will be determined in early cases in which the issue arises.

Moreover, Section 6.5(b) provides that if a proceeding is commenced to recover payment and it is determined that a contracting body, Contractor or Subcontractor acted in bad faith, then a reasonable attorney’s fee and expenses may be awarded.

This subsection relating to attorney’s fees contains the language appearing in Section 6.5(a) that **“An amount shall be deemed to have been withheld in bad faith to the extent that the withholding was arbitrary or vexatious”**, but does not contain the provision that an amount shall not be deemed to have been withheld in bad faith to the extent it was withheld pursuant to Section 6.4. Although this well may be yet another drafting error by the legislature, it may be some time until this ambiguity is resolved, either by way of amendment or by litigation.

6. Modifications of Protection of Labor and Material Payment Bonds

Perhaps that most far-reaching provision of the Amendments is contained in Section 6.9(b), which provides:

“Once a Contractor has made payment to the Subcontractor according to the provisions of this act, future claims for payment against the Contractor **or the Contractor’s surety by parties owed payment from the Subcontractor which has been paid shall be barred.”**

The significance of this provision cannot be overemphasized. Stated alternatively, Section 6.9(b) means that if a bonded prime Contractor makes payment to a Subcontractor, but the Subcontractor fails to pass payment down to a sub-Subcontractor or supplier, any action by the sub-subcontractor or supplier (or any lower tier Subcontractor or supplier) against the Contractor or its surety will be barred. In

effect, this converts all public works contract bonds on projects subject to the Amendments to single tier payment bonds on projects subject to the Amendments to single tier payment bonds, and anyone who is not in privity with the prime Contractor should not assume that they will have recourse to a payment bond merely because public work is involved.

VI. NON-STATUTORY REMEDIES - CLAIM FOR BREACH OF CONTRACT

A. Legal Proceedings.

B. Mediation/Arbitration. Whether a dispute may be -- or must be -- submitted to arbitration will depend on the contract between the parties. The AIA General Conditions A2011997 (Sections 4.5 and 4.6) require that any claim arising out of or related to the contract is subject to mediation as a condition precedent to arbitration or the institution of legal or equitable proceedings by either party. A mechanism is provided for resolution of claims by mediation in accordance with the Construction Industry Mediation Rules of the American Arbitration Association. If the parties are unable to resolve disputes by mediation, there is provision for arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association.

C. Examples of Actions.

1. Suit for Retainage. This is probably the most frequent basis of dispute between a prime Contractor and Owner and a Subcontractor and its prime Contractor.

2. Impact. This type of suit might include claims for delay damages (where a Contractor has been unduly delayed in being given access to the work) acceleration (where Contractor is compelled to complete a project earlier than according to contract, thus incurring overtime) or for improper coordination of subcontractors by the general Contractor (which can result in added expense to the Subcontractor).

3. Improper Termination. Where a party terminates the contract and the terminated party believes that termination to be a breach of contract.

PENNSYLVANIA CONTRACTOR AND SUBCONTRACTOR PAYMENT ACT -
SUGGESTED PAYMENT CLAUSE FOR SUBCONTRACT AGREEMENT

Payments will be made to SUBCONTRACTOR pursuant to applications for payment in the form attached hereto and made a part hereof, which are to be submitted, together with supporting invoices, no later than the _____ day of the month, representing the value of labor performed and/or material installed through and including the last day of the prior month. Applications for payment received after the _____ day of the month will not be processed for current billing. Each progress payment will be made to SUBCONTRACTOR upon the later of (i) fourteen (14) days after CONTRACTOR receives payment therefor from Owner or (ii) fourteen (14) days after CONTRACTOR receives SUBCONTRACTOR's invoice therefor, on the basis of ninety percent (90%) of the value of the labor performed and/or material installed, and properly reflected in the applicable application for payment, except for deficient work and/or for failure to perform in accordance with the terms and conditions of the SUBCONTRACT. A partial release of claims and liens, covering all periods for which prior progress payments were made, will be required to be signed and delivered by SUBCONTRACTOR with each application for a progress payment and a final release of claims and liens must be signed and delivered by SUBCONTRACTOR before final payment is made. The releases of claims and liens will be in the forms attached hereto. Final payment and retainage will be issued to SUBCONTRACTOR upon the later of (i) fourteen (14) days after CONTRACTOR receives payment therefor from Owner or (ii) fourteen (14) days after CONTRACTOR receives SUBCONTRACTOR's invoice therefor, except for deficient work and/or for failure to perform in accordance with the terms and conditions of the SUBCONTRACT. Notwithstanding anything contained in the SUBCONTRACT to the contrary, receipt of payment by CONTRACTOR from Owner on account of progress payments and/or final payment, as the case may be, shall be a condition precedent to CONTRACTOR'S obligation to pay SUBCONTRACTOR on account of progress payments and/or final payment, as the case may be. SUBCONTRACTOR acknowledges and agrees that it will hold all payments which it receives under the SUBCONTRACT as a fiduciary under a constructive trust for the benefit of all of its subcontractors and suppliers and for no other purposes. If SUBCONTRACTOR breaches its fiduciary obligations with respect to such payments, SUBCONTRACTOR acknowledges that CONTRACTOR will suffer irreparable harm therefrom, and that CONTRACTOR shall have the right to seek immediate injunctive relief and/or to exercise other equitable remedies in addition to legal and other remedies available under the SUBCONTRACT or otherwise.

PENNSYLVANIA CONTRACTOR AND SUBCONTRACTOR PAYMENT ACT -
SUGGESTED DISCLOSURE FORM FOR SUBCONTRACT AGREEMENTS

CONTRACTOR hereby discloses that under the terms of the contract between Owner and CONTRACTOR, CONTRACTOR is required to invoice the Owner by the _____ day of each month for the cost of the work furnished and incorporated into the project through the last day of the prior month, less previous payments and less _____ percent (_____%) as retainage. If the invoice is approved by the Owner or its representative, payment is to be made to CONTRACTOR within _____ days of the Owner's receipt of the invoice. The balance of the payments are to be made by the Owner to CONTRACTOR within _____ days after all work of CONTRACTOR has been fully completed to the satisfaction of the Owner and accepted. [Insert any other relevant date of payment provisions arising under the General Contract or modify as required.]

SUBCONTRACTOR acknowledges that it has reviewed the preceding paragraph prior to signing the SUBCONTRACT.