

**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION  
PHILADELPHIA CHAPTER  
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**GETTING PAID  
PRE-CONSTRUCTION DUE DILIGENCE**

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## 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 1987 edition of A201 (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 --- your 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. A copy of the loan documents is 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 the 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 2.1.2 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 - Bankers have access to information that individuals cannot easily get themselves --- credit reports, for example. A contractor's banker has an interest in the contractor being paid; otherwise, the contractor could be forced to use its own resources, such as lines of credit, to meet its obligations. The contractor's bank should be cooperative in assisting the contractor in learning as much about the owner as possible.

- B. Contractor's Bonding Company - The surety has a vested interest in a contractor's performance and in the contractor's ability to obtain timely payment. Payment by the owner is generally a condition precedent to the bonding company's surety obligation. The bonding company's obligations could be extinguished by an owner's failure to make payment. However, if a contractor is not paid it will adversely affect the contractor's financial condition and could increase the bonding company's risk relative to other projects of the contractor bonded by the surety. The nonpayment would decrease the contractor's working capital and also reduce net assets available to indemnify the bonding company if claims are made against a bond. Therefore, the surety should be interested and cooperative in assisting the contractor in obtaining financial information about the owner.
- C. Owner Financial Questionnaire - AGC Document No. 690.1. Who should send it --- have your surety agent send it on bonded and non-bonded jobs; surety has interest in all your work; payment problem on one job can affect all projects.
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 - This is important in order to identify the architect's fee which, is payable out of the construction loan proceeds, will affect the amount of funds available to pay the contractor. It will also identify the architect's project administration responsibilities and its insurance obligations.

- e) Owner's Property Insurance and/or Builder's Risk Policy - If the owner does not have adequate insurance, the funds available for construction could be adversely affected should losses occur during construction.
- f) Architect's Professional Liability Policy - In addition to verifying that the architect has errors and omissions coverage, the policy will identify the nature and extent of such coverage and the degree of potential exposure the owner may have to claims relating to design errors.

#### IV. SUMMARY

An owner, in an effort to obtain assurances that the contractor can fulfill its obligations, will often require financial and performance information from the contractor and possibly a surety bond before awarding the contract. Contractors have similar interests and also a right to obtain information sufficient to assess an owner's ability to meet its payment obligations.

#### V. 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 subcontractors' 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."

## VI. BACKCHARGES

A. A charge by a prime contractor to a subcontractor for costs which the prime contractor considers to be compensable. A backcharge is simply a set-off against the next payment. Dispute arises in context of General Conditions items, such as temporary site facilities - utilities, hoists, scaffolding.

### B. Sample Clauses

#### 1. AIA Document A401 Subcontract (1987 Edition)

Article 3.3.2 Except as may be indicated in this Agreement, the Contractor agrees that no claim for payment for services rendered or materials and equipment furnished by the Contractor to the Subcontract shall be valid without prior notice to the Subcontractor and unless written notice thereof is given by the Contractor to the Subcontractor not later than the tenth day of the calendar month following that in which the claim originated.

#### 2. AGC Document No. 600 subcontract (1984 Edition)

Article 10.1.1 Notice to Cure. If the Subcontractor refuses or fails to supply enough properly skilled workers, proper materials, or maintain the Schedule of Work, or it fails to make prompt payment for its workers, sub subcontractors or suppliers, disregards laws, ordinances, rules, regulations or orders of any public authority having jurisdiction, or otherwise is guilty of a material breach of a provision of this Agreement, and fails within three (3) working days after receipt of written notice to commence and continue satisfactory correction of such default with diligence and promptness, then the Contractor, without prejudice to any rights or remedies, shall have the right to any or all of the following remedies:

- (a) supply such number of workers and quantity of materials, equipment and other facilities as the Contractor deems necessary for the completion of the Subcontractor's Work, or any part thereof which the Subcontractor has failed to complete or perform after the aforesaid notice, and charge the cost thereof to the Subcontractor, who shall be liable for the payment of same including reasonable overhead, profit and attorney's fees;
  - (b) contract with one or more additional contractors to perform such part of the Subcontractor's Work as the Contractor shall determine will provide the most expeditious completion of the total Work and charge the cost thereof to the Subcontractor...
3. Comments - AGC permits contractor to backcharge subcontractor without any prior notice that contractor considers the service compensable.

## VII. TERMINATION

### A. By Subcontractor

The AIA (Article 4.7.1) provides that if the contractor does not pay the subcontractor within seven (7) days from the time payment should be made, the subcontractor may upon seven additional days written notice to the contractor, stop the work. Article 7.1.1 of the AIA subcontract form allows the subcontractor to terminate the subcontract for nonpayment of amounts due for 60 days or longer and the subcontractor is not required to give the contractor an additional seven days notice of its intent to terminate. It will then be entitled to recover payment for work executed and for "any proven loss ... including reasonable overhead, profit and damages."

Under the AGC subcontract (Article 5.2.6) the subcontractor has a right to stop the work if payment is not received within seven (7) days after the date payment is due and after giving an additional seven (7) days written notice to contractor. If the subcontractor's work has been stopped for thirty (30) days because the subcontractor has not received progress payments, the subcontractor may terminate the subcontract upon giving the contractor an additional seven (7) days written notice.

B. By Contractor

Article 7.2.1 of the AIA subcontract requires that the subcontractor “persistently or repeatedly” fail to meet its obligations before the contractor may terminate. The contractor is required to give the subcontractor seven days to cure the default and then an additional seven days written notice. Article 10.1.2 of the AGC form, by contrast, allows the contractor to terminate by giving the subcontractor notice of default and as little as three (3) working days to cure the default. If the subcontractor fails to cure the default within that time, it may be terminated upon receipt of written notice from the contractor. Default is defined to include the failure to diligently prosecute the work or the failure to perform any covenant of the subcontract.

VIII. ARBITRATION

Article 6 of the AIA also calls for arbitration between the contractor and subcontractor. It precludes, however, any consolidation with arbitration proceedings in which the architect, or its employees or consultants, is a party. This scheme creates a danger that the subcontractor will be forced to pursue remedies in separate forums and be exposed to inconsistent results.

This is an area where the AGC subcontract may be more beneficial to subcontractors than the AIA form. Article 14 of the AGC subcontract simply establishes arbitration as a remedy between the two parties. The claims and disputes of the owner, contractor and subcontractor and other subcontractors involving a common question of fact or law may be heard by the same arbitrators in a single proceeding.

IX. OTHER AREAS

A. Indemnification

B. Warranty

C. Time of Commencement and Completion - Scheduling

X. PRIME CONTRACTOR SUBCONTRACT FORMS