CONSTRUCTION PROJECT PAYMENTS: Fundamental Challenges & Solutions

Typical Contract Provisions

The processes and requirements for a contractor to obtain payment on any particular job are typically set forth in its contract with the owner or upstream contractor. These provisions generally provide the prerequisites for the contractor’s right to receive payment, as well as the methodology for calculating payment, the paperwork the contractor is required to submit with its payment application, the timing for payment, and the contractor’s rights in the event payment is not made.

As a matter of negotiated contracts, these payment provisions can run the gamut, but here are some of the more common ones.

Typical Payment Cycle

Contractual payment cycles can vary from payment being due upon invoice receipt to payment being due 60 days or more after invoice receipt. Common payment cycles are between 15 and 30 days, which is important for reasons beyond knowing when the check is in the mail.

It is important to understand the upstream payment cycle for purposes of establishing appropriate downstream processes so that subcontractors and suppliers understand what type of documentation is required for payment and when such documentation must be provided to the upstream contractor to pass through to the owner.

In addition, some state lien laws include deadlines that are tied to submissions...
of lien waivers (which contractors are typically required to submit along with a payment application) that may become important if there is a particularly lengthy payment cycle.

For example, Georgia's lien law mandates the use of a statutory form for lien waivers that makes such waivers conditional (i.e., effective only upon the receipt of payment).

However, the Georgia statute also provides that “[s]uch amounts shall conclusively be deemed paid in full” no later than “[s]ixty days after the date of execution of the waiver and release, unless prior to the expiration of said 60 day period the claimant files a claim of lien or files in the county in which the property is located an affidavit of nonpayment.”

When a contract contains a 60-day payment cycle and a requirement that lien waivers be submitted with payment applications, statutory provisions like Georgia's present an administrative burden on contractors to preserve their lien rights.

Other states have different requirements. For example, New York's lien law allows the execution of lien waivers simultaneously with or after payment has been made.

Because lien laws and the enforceability of lien waivers vary from state to state, contractors should have an understanding of the applicable state law requirements prior to signing a contract or starting work on a project.

In the absence of a contractual payment cycle (or sometimes in lieu of a contractual provision, depending on the applicable state law), many jurisdictions have prompt payment acts that prescribe a time limit for an upstream contracting party to make payment to a downstream party.

For example, New York’s prompt payment law requires an owner or upstream contractor to approve or disapprove a submitted invoice within 12 days. An owner must then pay the invoice no later than 30 days after approval thereof, and an upstream contractor must pay a subcontractor the funds received from the owner. Prompt payment acts vary widely among jurisdictions in applicability and scope, including whether parties can contract around any statutory payment requirements, and should be reviewed as part of the contract negotiation for a given project.

Supporting Documentation

It is critical to understand what documents contractors are required to submit in order to receive timely and complete payment. An owner or upstream contractor may rightfully withhold payment until the requesting contractor has submitted all required documentation. Documents that may be required include:

1) an executed payment application, using either a form attached to the contract or a standard industry form such as the AIA G702-1992, Application and Certificate for Payment,

2) documentation that substantiates the payment requested, which may differ depending on the contract's pricing method,

3) executed lien waivers and/or claim waivers, and

4) other documentation evidencing that the requesting contractor has made, or intends to make, payments to all subcontractors and suppliers providing labor, materials, or equipment for the project. This last item could include statements of account or affidavits of payment.

Contractors seeking payment should know and understand all contractually required documents and include them with their payment applications. Waiver documents, particularly claim waivers that go beyond simply waiving the contractor's lien rights to the extent of the payment received, should be carefully reviewed prior to execution. If a contractor has outstanding or potential claims, an unqualified, executed claim waiver could foreclose any right to pursue those claims in the future. Contractors should accordingly identify and reserve any such claims with as much specificity as possible.

Documents required for the final payment application typically include documents necessary for turnover or project closeout, such as: 1) as-built drawings, 2) operation and maintenance manuals, 3) manufacturers' warranties or other warranty documentation, 4) evidence of performance completion tests, if applicable, and 5) final lien and claim waivers from the contractor and all subcontractors, and consent to final payment from the contractor's surety. Receipt of final payment often acts as a waiver by the contractor of all claims.
Certified Payrolls

Some construction projects, typically government or public works projects, may require a contractor to submit weekly certified payrolls and statements of compliance in accordance with various federal or state prevailing wage laws. Failure to accurately complete these certified payroll reports in a timely manner can delay receipt of payment.

Contractors should understand any such reporting requirements prior to starting work and prior to contracting (since the requirement may affect the contract price and may influence the requirements imposed on subcontractors) and ensure that such provisions are properly flowed down to lower tiers.

Certification Requirements

Government projects (and perhaps some private projects, depending on the contract language, funding sources, or payment application forms) also typically require a contractor requesting payment to certify certain items with each payment request. These certifications may include:

1) that the requested payment is only for work performed “in accordance with the specifications, terms, and conditions of the contract,”

2) that all payments due to subcontractors and suppliers from previous payments have been made,

3) that timely payment to subcontractors and suppliers will be made from the requested payment, and

4) that the payment request does not include amounts that the contractor intends to withhold or retain from a subcontractor or supplier.

In addition to the payment request certifications, federal government contracts require a contractor asserting a claim greater than $100,000 to certify the claim under Federal Acquisition Regulation (FAR) § 52.233-1(d)(2) as follows:

I certify that the claim is made in good faith; that the supporting data are accurate and complete to the best of my knowledge and belief; that the amount requested accurately reflects the contract adjustment for which the Contractor believes the Government is liable; and that I am duly authorized to certify the claim on behalf of the Contractor.

Contractors must carefully evaluate the requirements and relevant facts needed before making any such certifications because the penalty for false certifications can be significant. False Claims Acts, at the federal level and increasingly at the state level, contain harsh penalties for improper billings submitted on government projects. These penalties can include statutory penalties per each “false claim,” three times the amount of damages to the government, and all costs, including attorneys’ fees and expenses, incurred by the government in prosecuting a civil action against a contractor.

Electronic Billing

Contracting parties are increasingly turning to electronic billing software to manage the payment application process. This software can be useful for managing collection of the various items contractors are required to submit for payment, and ensuring that payment is only made after all items are appropriately submitted. This eases the administrative burden on the contracting parties (particularly for the upstream contractor that would otherwise have to manually track all submissions), but there are typically subscription costs associated with using the software. These costs should be identified in advance to allow participating contractors and subcontractors to accurately price the job and avoid surprises.

In addition, a contractor submitting payment applications through such an electronic system should carefully review its forms, especially lien and claim waiver documents, to ensure it has accurately completed the forms and reserved claims as allowed or necessary. If the software does not allow the forms to be completely filled out, then the parties should discuss an alternative reporting system.

Billing Based on Percentage Completed vs. Cost-Plus vs. Milestone Achievement

The backup that contractors are required to maintain and submit to substantiate payment requests differs depending on the contract pricing methodology.

Billing under lump-sum contracts typically occurs monthly and is based on a schedule of values that is prepared by the contractor and approved by the owner or upstream contractor prior to starting work. The schedule of values should be assembled to accurately reflect the appropriate proportion that each item has to the overall lump-sum contract price. Otherwise, an imbalance between the work performed and the payments received could arise during construction. Contracts often address this issue by requiring a “balanced” schedule of values, or a schedule of values that is not “front-end loaded.” (For more information on the risks of front-end loading, read “Taking Risks with Numbers: How Far Can You Go?” by Susan L. McGreevy and Kathryn I. Landrum in the September/October 2014 issue.)
In any case, the contracting parties should agree on the schedule of values in order to facilitate the payment process.

With each payment application, the contractor reviews its progress and inserts the percentage of each scheduled value that has been completed by the end of the pay period. The sum of these amounts is the amount due to the contractor for the pay period – less prior payments, retainage, and any other amounts the owner or upstream contractor is entitled to withhold. The owner or upstream contractor and/or other party as the contract may allow (such as a consultant, architect, or the project lender), reviews the contractor’s payment application, compares the asserted percentages complete with its own observations of the contractor’s progress, and proposes revisions if necessary.

For construction contracts under which the architect performs contract administration, the architect is often required to issue a certificate of payment to the owner containing the architect’s judgment as to the appropriate percentages complete and the amounts due. In such contracts, the timing of the owner’s payment obligation is often tied to receipt of the architect’s certificate of payment. Disagreements among the parties regarding the project’s progress can delay a contractor’s receipt of payment or lead an owner or upstream contractor to withhold disputed amounts, so it is important to quickly and accurately resolve any such issues.

For cost-plus contracts under which the price is based on the cost of the work plus a markup for the contractor’s profit (regardless if there is a guaranteed maximum price), the required backup for payment applications may be different.

While a contractor may still use a schedule of values to track the progress of the job, the contractor typically is also required to submit appropriate evidence of the costs incurred to perform the work, including:

1) payrolls accurately demonstrating labor costs,
2) invoices from subcontractors, suppliers, and/or other vendors and evidence of payment of the same, and
3) other evidence as may be required to reasonably support the contractor’s costs.

A contractor performing cost-plus work should be familiar with any definition of the allowable or reimbursable cost items contained in its contract. Certain costs a contractor may internally charge to a project may not be reimbursable under the specific terms of a particular contract.

With cost-plus contracts, the owner or upstream contractor often has the right to audit the contractor’s records to verify the amounts and the propriety of costs charged to the job. It is very important for contractors performing cost-plus work to maintain accurate job-cost records, including backup (payrolls, invoices, evidence of payment, etc.) for audit purposes and in case a dispute arises.

If a contractor overcharges the owner or upstream contractor, then it is generally responsible for refunding the overpayment, with interest. The parties’ contract may also require the contractor to reimburse the owner or upstream contractor for the costs of the audit in that scenario.

Even with an overall cost-plus contract pricing methodology, contracting parties can avoid common disputes that arise over the propriety of various “overhead” or “general conditions” charges by agreeing in advance on a lump-sum amount for such costs. In that case, a contractor would typically allocate the agreed lump sum over the expected duration of the project and bill a flat rate with each monthly progress payment application.

Similarly, parties can agree on daily rates to cover such costs in the event of change orders that extend the duration of the project. Typically in this scenario, the agreed lump-sum amounts would be exempt from audit.

Another common contract payment methodology provides for payment based on the achievement of milestones identified and agreed upon by the parties. Under this method, there is typically a lump-sum contract price with certain percentages of the price allocated to the achievement of various milestones. The contractor is entitled to payment upon achievement of each milestone and should submit the appropriate backup to substantiate that the milestone has been achieved.

**Claims & Change Orders**

Contract requirements for the presentation and resolution of claims and change orders are important provisions for the parties to understand, as disputes over entitlement to claims and change orders are likely the most common construction project disputes that lead to arbitration or litigation.

Early claim identification is generally desirable for all participants on a construction project. Contractors benefit from promptly bringing such issues to the table and obtaining resolution while these issues are fresh in the participants’
minds, allowing contractors to receive additional payments or schedule relief to which they are entitled.

For owners and upstream contractors, early claim identification avoids end-of-job surprises and may provide flexibility for mitigating the financial and schedule impacts of an issue. For all parties, early claim identification may reduce the incidences or costs of formal dispute resolution such as arbitration or litigation.

Construction contracts often require a contractor to submit a claim or change order request within a certain number of days after the occurrence of the event giving rise to the contractor’s claim or request.

For example, the standard AIA general contract conditions require claims to be initiated “within 21 days after occurrence of the event giving rise to such Claim or within 21 days after the claimant first recognizes the condition giving rise to the Claim, whichever is later.”

Owners and upstream contractors often insist on shortening the timeframe, removing the discovery language, and inserting affirmative waiver language such that a contractor failing to provide timely notice forever waives its claim or entitlement to a change order. These provisions help insulate owners and upstream contractors from late claims or previously undisclosed claims being submitted at the end of a project after all or most of the work is complete.

Contractors can attempt to negotiate greater flexibility to assert claims or change order requests, but no matter what the final contract language, a contractor and especially the project management team must be acutely aware of these contract requirements. Failure to follow the contractual procedures may result in a waiver of the claim.

Contractors should also have systems in place for segregating and maintaining backup documentation for claims and change orders. This backup is critical for pricing claims and change orders, and contractors are often required to submit such documentation for the owner or upstream contractor to review before payment.

Change orders may be priced using different methodologies than the base contract price. Contracts typically allow for change orders to be priced based on: 1) a negotiated lump sum, 2) the application of unit prices to additional work, 3) the cost-plus method, 4) time and materials, or 5) some combination of the different methodologies.

In addition, most construction contracts allow the owner or upstream contractor to direct a contractor to perform a change before or without an agreement on the price of the change. Such “force account” work is commonly priced on a cost-plus or time and materials basis.

Therefore, even if the underlying contract is a lump-sum contract, the contractor should have procedures in place to accurately track labor hours and other costs expended on change order work. Failure to maintain such information can prejudice the contractor’s claim for payment.

After a change order is agreed upon and executed by the parties, the contractor will typically requisition for payment of the changed work with its monthly progress payment request and should include whatever backup is required to substantiate the amount requested under the chosen pricing methodology.

**Practical Billing Considerations**

- Consider contracting for lump sum or flat rates where possible
- Consider attaching to the contract agreed-to forms for payment applications, lien waivers, etc.
- Understand the documentation available and required for payment
- Understand the timing and documentation required for submission of claims and change order requests
- Have the payment packages in the correct and contractually required format
- Have the required invoicing and supporting payroll and cost data assembled
- Know the differences between “corporate” reports and commonly accepted backup
- Have procedures in place for accurately tracking labor hours and other costs expended on change order work even if the base contract is a lump sum contract
- Try to negotiate payment of undisputed amounts in the event of a dispute

**Conclusion**

Understanding contractual requirements regarding payment procedures and ensuring that the project management team understands those requirements are necessary to minimize the risks of delayed payments or inadvertent waiver or reduction of claims. Negotiating contract terms and establishing procedures to make it easier for the project team to comply with the payment requirements can reduce costly disputes and benefit a contractor’s bottom line.
Endnotes

1. O.C.G.A. §44-14-366(c), (d) (2009).
2. Ibid. §44-14-366(f)(2).
5. See ibid. §53.281(b)(3) (providing that a conditional lien waiver or release is effective only if evidence of payment to the claimant exists); ibid. §53.283 (stating that “[a] person may not require a claimant or potential claimant to execute an unconditional lien waiver and release” unless the claimant has received payment).
7. Ibid. §756-a(3)(a)(ii).
8. Ibid. §756-a(3)(b)(ii).
9. FAR §52.233-1(d)(2)(iii).
11. See, e.g., Laquila Group, Inc. v. Hunt Const. Group, Inc., 997 N.Y.S.2d 99 (N.Y. Sup. Ct. 2014) (subcontractor argued that unqualified payment application “became simply an acknowledgment by [plaintiff] of its payment receipt” because the software did not allow the subcontractor to list reserved claims on the “reverse side” of the form, as the form required).

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