

*Risk Management Issues
For Contractors During
Troubled Times*

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THE KEY POINTS TO CONSIDER

As you draft contracts, or assess how to either pursue payment or prevent potential collection efforts during these tough times, focus on these points:

- Contract Payment Issues
- Dangers/Protections (depending on where you sit)
- Leverage

CONTRACT PAYMENT ISSUES

The following are items you should review and consider as you negotiate the contract or are assessing payment problems that have since developed:

- Proof of funding
- Timing of payment
- Material costs-price escalation clauses
- Agreed to change order mark-ups
- Defining recoverable costs in non-fixed price contracts
- Minimize retainage

1) Proof of funding

- What assurances do you have that the Owner can pay for the project?
- The General Contract should have a provision providing the Contractor the right to request and obtain proof that the Owner has funding sufficient to satisfy the Contract price. The provision should provide that the Contractor may at any time before or during performance of the work, upon some specified written notice, review relevant records to confirm that the Owner remains capable of satisfying the Contract price and any Change Orders thereto. The provision should provide that the Contractor can terminate for cause: 1) if the Owner refuses to allow the Contractor to review the documents; or 2) should the Contractor reasonably determine that the Owner does not have sufficient funds to pay for the work.
- There should be a corresponding 'termination for cause' provision specifying the Contractor's measure of damages in such instances.

2) Timing of Payment

- Shorten the time frame between work and payment as much as possible.
- Attempt to obtain some payment “up front,” to cover administrative costs incurred before work actually begins.

3) Material Costs

Try to minimize the impact of material costs.

- Insert a provision in the Contract providing that the Contractor will be paid upon delivery and acceptance of material on-site or at some other designated location. This minimizes carrying costs the Contractor would otherwise have to incur between the time it purchases and actually installs the applicable material.
- Beware of the potential for sharply escalating material costs.
- **Price Escalation Clauses** provide protection in the Contract.
- As its name implies, a Price Escalation Clause provides the right to seek increased compensation if a material price increases between specified intervals.
- Government price indexes as well as industry and trade association data collections can serve as price measuring tools.
- When using a Price Escalation Clause make sure to specify the material price assumed in the Contract as a starting point.
- Other means may also be pursued to collect material price increases.
- **Force Majeure** clauses excuse performance based on ‘Acts of God’, disasters, and miscellaneous other issues that occur, ostensibly beyond the parties’ control.
- Restatement 2d of Contracts, § 261 (Discharge by supervening impracticability)- “Where, after a Contract is made, a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the Contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.”-The Comment to the restatement explains that, “mere market shifts or financial inability do not usually affect discharge under the Rule stated in this Section.” See **Jason Johnson, Esq., “Protection Against Sharply Increasing Material Prices,” CFMA Building Profits (April 2006).**

4) Change Orders

Insert into the Contract an Agreed to mark-up for the Contractor's fee on any change orders.

5) Define Recoverable Costs

In any non-fixed price contract, where the Contractor will be seeking to recover costs, make sure that the recoverable costs are clearly defined in the contract. The following are items that you may seek to have covered:

- Wages paid for labor in the Contractor's employ;
- Salaries of the Contractor's employees when stationed at the Field Office or those on the road expediting production or transportation of materials and equipment;
- Cost of employee benefits and taxes (Workers' Compensation, Unemployment Compensation, Social Security, etc.);
- Reasonable transportation, travel, hotel and moving expenses of the Contractor's personnel;
- Cost of materials, utilities, supplies and equipment;
- Contractor's payments to Subcontractors;
- Rental charges of all necessary machinery and equipment;
- Costs of liability insurance and bonds;
- Permits, fees, licenses;
- Costs associated with equipping, operating, maintaining, and mobilizing the Field Office;
- Demobilizing the Field Office;
- Reproduction costs (photocopying), telephone costs;
- Water, power and fuel costs;
- Costs of removing non-hazardous materials;
- Costs incurred due to an emergency affecting the safety of persons and/or property;
- Legal (including mediation and arbitration costs) other than those arising from disputes between Owner and Contractor;
- Additional costs incurred from laws or ordinances, rules and regulations enacted post-Contract;
- **A safety net** – all costs incurred in the performance of the work, or in any way connected with the project and not included in the contractor's fee, that are reasonably inferable from the contract documents.

- **This is not an all inclusive list**

6) Minimize Retainage

- Minimize retainage and/or provide for reduction of retainage when achieving certain milestones (i.e. when Contractor achieves fifty percent completion, retainage shall be reduced from ten percent to five percent).

DANGERS/PROTECTIONS
(DEPENDING ON WHERE YOU SIT)

- Pay when paid;
- Lien waivers;
- Lien Bond Requirements;
- Contractual limitation periods;
- Claims process;
- Recognizing Potential Set-offs;
- Receiving money as a trust fund.

1) Pay When Paid

Which one of the following constitutes a valid and enforceable pay when paid provision?

- “Each project payment will be distributed to the Subcontractor within three (3) working days *after* the Contractor receives payment from the Owner....”
- “The Contractor shall promptly pay the Subcontractor upon receipt of payment from the Owner, *out of the amount paid to the Contractor on account of such Subcontractor’s portion of the work*, the amount to which said Subcontractor is entitled....”
- “Payment to the Subcontractor is to be directly contingent upon the receipt by the General Contractor of payment from the Owner.”

According to the Appeals Court in *Framingham Heavy Equipment Company v. John T. Callahan & Sons, Inc.*, 6 Mass.App.Ct 171 (2004), only the last quoted provision constitutes an enforceable pay when paid provision. The others serve only to postpone payment for a reasonable time after requisition, “so as to afford the general contractor an opportunity to obtain funds from the Owner.” *Id.*

2) **Beware of Lien Waivers**

- Being careful not to waive lien claims for disputed amounts due.
- Being careful not to waive all claims such as the following requires:

Contractor acknowledges and agrees that it has been paid all sums due on the project and, therefore, waives and releases any and all claims for payment as of this date, including without limitation all liens and rights of lien on such real property for labor and materials... and for any other services performed or furnished through this date which Contractor ever had, now has, or may herein ever have through this date against

3) **Beware of Lien Bond Requirements**

Lien bond requirements are common. Nonetheless, some such provisions really attempt to squeeze the Contractor. The emphasized language below is an example of such language.

- “If any Subcontractor or lower tier Sub-subcontractor or material supplier, records a Notice of Contract or otherwise encumbers the project property, the Contractor shall immediately record a lien bond pursuant to G.L. c. 254, §14 at its own cost. ***It shall not be a defense to this requirement that the Contractor claims non-payment by the Owner.***”

4) **Beware of the Claims Process**

Most contracts contain a claims process and, in such instances, the claims process must be followed, or claims can be waived.

- “A Contractor seeking to recover payment in excess of the Contract price must follow the procedures set out in the Contract.” *Sutton Corp. v. MDC*, 423 Mass. 200, 207 (1996); *Chiappisi, et al. v. Granger Construction Co., Inc., et al.*, 352 Mass. 174 (1967).

For more on this, see the detailed article that follows later with these materials.

5) *Set-offs to Payment*

The following provisions can be effectively used as set-offs to payments due the Contractor (or Subcontractor), thereby minimizing the payment due:

- the value of defective work;
- third-party claims;
- lien claims;
- reasonable evidence that the work can not be completed for the unpaid balance of the Contract sum;
- damage claimed by the Owner;
- reasonable evidence that the work will not be timely completed.

6) *Holding Money as a "Trust Fund"*

The Owner may attempt to put pressure on the Contractor/Subcontractor to "do the right thing" with any payment being provided, to minimize the risk of lien claims. One way to do this is to insert a provision providing for the following as a condition to payment:

- the Contractor/Subcontractor only receives funds in trust for its subcontractors and material suppliers with an express representation that all amounts have been paid and that any amounts received are being fully;
- that the payment received will be completely disbursed consistent with the requisition;
- that no claims are outstanding other than as represented in the current requisition for payment; and
- that this payment will result in full payment to all subcontractors and suppliers, and extinguish all existing payment claims.

LEVERAGE

The following are all tools to assist in securing a future judgment:

- the ability to collect fees and costs arising from pursuit of payment;
- mechanic's liens;
- attachments (Mass.R.Civ.P. 4.1);
- attachments via trustee process (Mass.R.Civ.P. 4.2);
- temporary restraining orders and preliminary injunctions (Mass.R.Civ.P. 65);

- use of ex parte motions;
- reach and apply;
- bond claims;
- piercing the corporate veil; and
- fraud claims.

1) **Collect Your Fees and Costs**

Insert a provision in the contract entitling the Contractor to recover reasonable attorney's fees and costs (in addition to interest) on any overdue payment. Otherwise, the potential cost of litigation will be used as leverage against the Contractor.

2) **Mechanic's Liens-The Contractor's Best Friend**

- Comply with the statutory requirements-the following is a checklist of steps:
 - Written Contract
 - Notice of Contract
 - Statement of Account
 - Filing Suit
 - Recording Attested Copy of Complaint at the Registry
 - *Notice to owner is required for Subcontractors and both Notice to Owner and Notice of Identification are required for Sub-subcontractors and material suppliers.
- Assess whether the lien rights flow to the property or only the leasehold interest?

The Following are defenses to mechanic's liens:

- Failure to follow the statutory process, See *Ng Brothers Construction, Inc. v. Cranney*, 436 Mass. 638 (2002); *East Coast Steel Erectors, Inc. v. Ciolfi*, 417 Mass. 602, 605 (1994)(mechanic's lien statute is strictly construed).
- The 'due or to become due' defense; See *Bloomsouth Flooring Corporation v. Boy's and Girl's Club of Taunton, Inc.*, 440 Mass. 618 (2003).

For more on mechanic's liens, see the article following these materials.

3) Attachment-Rule 4.1

- This can be used for real estate, goods, chattel and other property.
- **There must be a reasonable likelihood of success** in an amount, including interest and costs, equal to or greater than the attachment sought over and above available liability insurance.

4) Trustee Process-Rule 4.2

- **The reasonable likelihood of success** standard applies. Rule 4.2(g).
- The Trustee, "shall disclose plainly, fully, and particularly what goods, effects, or credits, if any, of the defendant were in the hands or possession of the Trustee when the Trustee Summons was served upon him." Rule 4.2(d).
- The attachment only captures what is then on account.

5) Temporary Restraining Orders\ Preliminary Injunction -Rule 65

- Temporary restraining orders expire not more than 10 days after being issued unless extended, with good cause shown-Rule 65(a).
- No preliminary injunction shall issue without notice to the adverse party-Rule 65(b).
- Preliminary injunctions and restraining orders shall not issue, "except upon the giving of security by the applicant, in such sum as the court deems proper, for the payment of such costs and damages as may be incurred or suffered by any party who is found to be wrongfully enjoined or restrained," unless the court, for good cause shown, orders otherwise. Rule 65(c).
- The Court balances the burdens/equities before issuing these.

6) Ex Parte Motions

Sometimes ex parte process is necessary and reasonable. It can be overused though and courts sometimes look unfavorably upon *ex parte* attempts. The following list some Rules requirements related to the *ex parte* process:

- For temporary restraining orders-"only if it clearly appears from specific facts shown by affidavit or by the verified complaint that **immediate and irreparable injury, loss, or damage will result to the applicant** or to the adverse party or his attorney can be heard in opposition."

- For attachments-“upon findings by the court that there is a reasonable likelihood that the plaintiff will recover judgment in an amount equal to or greater than the amount of the attachment over and above any liability insurance ... and ... (i) the person ... is not subject to the jurisdiction of the court ... or (ii) **there is a clear danger that the defendant if notified in advance ... will convey [the property]** ... or (iii) there is **immediate danger** that the defendant will damage or destroy the property to be attached.” Rule 4.1(f) (emphasis added).
- For Trustee Process-Person Not Subject to Court Jurisdiction, danger that the Defendant will withdraw the goods or credits or dissipate, damage or destroy the goods or credits.-Rule 4.2(g)
- 7) **Reach and Apply**-Does someone else owe money to the target defendant (is that defendant on any other projects?; has it pulled any other building permits?) If so, then add that party as a reach and apply defendant and move to attach its debt to your debtor.
- 8) **Bonds**-Is there a payment bond? If so, what is the bond’s claim process\limitations? Can you obtain useful discovery information via discovery of the surety?
- 9) **Piercing Claims:**

If the debtor/defendant entity has no assets, consider whether there are grounds to pierce the corporate veil. The following are the seminal related cases:

My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass. 614 (1968); *Pepsi-Cola Metro. Bottling Co. v. Checkers, Inc.*, 754 F.2d 10 (First Cir. 1985); *Evans v. Multicon Const. Corp.*, 30 Mass.App.Ct. 728 (1991).

- The *Evans and Pepsi Cola* cases provide the following twelve point analysis of points the Courts weigh, in assessing whether to pierce the corporate veil:
 - (1) Common ownership;
 - (2) pervasive control;
 - (3) confused intermingling of business activity assets, or management;
 - (4) thin capitalization;
 - (5) nonobservance of corporate formalities;
 - (6) absence of corporate records;
 - (7) no payment of dividends;
 - (8) insolvency at the time of the litigated transaction;
 - (9) siphoning away of corporate assets by the dominant shareholders;
 - (10) Nonfunctioning of officers and directors;

- (11) use of the corporation for transactions of the dominant shareholders; and
- (12) use of the corporation in promoting fraud.

It is typically difficult to succeed on a piercing claim but it should be considered, especially where the defendant/debtor is otherwise judgment proof.

10) *Fraud/Negligence*

- Did any of the defendant entity's principals or employees act negligently?
- Did any of its principals act fraudulently?

SUMMARY

1. Minimize payment risks through contractual measures.
2. Be careful of defenses to payment and make sure to pass them on to lower tier entities with whom you contract.
3. Aggressively move to collect payment.