

## Construction Contractors Should Assert Lien Rights Carefully

By **Poston Pritchett** and **Rick Shearer** (April 27, 2020, 6:09 PM EDT)

On April 13, the Superior Court of New Jersey, Appellate Division, ruled in *SAL Electric Co. Inc. v. The Pike Co. Inc.*[1] that a New York general contractor cannot escape suits from a subcontractor for allegedly overdue payments under their agreement by relying on separate contracts the general contractor had with supermarket chain Wegmans.

The court cited ambiguity and confusion over the interplay between the general contractor's prime contracts with Wegmans and its master subcontractor agreement with the subcontractor to perform electrical work.

Asserting lien rights is a highly technical endeavor. The failure of contractors and suppliers to precisely comply with statutory requirements when attempting to assert lien rights can warrant the permanent dismissal or at least partial exclusion of a lien, depending on whether the defect causes material prejudice to the general contractor or the property owner.[2]

What may seem like a mere technicality can be fatal to a subcontractor's lien and perhaps doom its only opportunity to receive payment from an owner for materials supplied or underlying work performed.

Contracts and lien rights are both critical to payment on a construction project. While the construction industry will debate for months and years to come whether COVID-19 qualifies as a force majeure event on a disrupted construction project, all parties on the project should be focused now on securing their payment rights. Failing to secure these rights could waive any right to additional time or costs.

Supply chains, labor and payments may be disrupted, all of which will affect critical paths, and the ensuing disputes will only serve to delay payment further. Factor in less demand for new projects due to financial uncertainty and cancellations of nonessential projects such as offices and entertainment and sports facilities and it becomes clear that payment disputes are looming.

Many contractors or suppliers will be placed in a position trying to obtain money owed for work rendered or supplies delivered or trying to avoid returning payments received before a payor's financial struggles or bankruptcy.



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Contractors, subcontractors and suppliers should take some important actions now to better control their futures and protect contract rights and cash flow. It is paramount that contractors posture now to protect and secure their respective interests by issuing notices as quickly as possible even though the full impact of a disruption may be unknown.

Understanding payment rights is all the more important on construction projects because the payment scheme on construction projects is complex, notwithstanding a pandemic. Work is usually performed and deliverables supplied before receiving payment.

The performing party is often several contracts away from the source of funds or ultimate payor, and history indicates these further-removed entities are at higher risk for being adversely affected by a payment default. These downstream parties must secure their payment rights, which they can do in three primary ways: contract remedies, recording liens, and bonds.

In planning and preparing to assert these rights, downstream contractors, subs and suppliers should review their lien or payment bond rights in order to prepare for the potential of nonpayment in the coming months. All entities need to meet what is required in their contracts in terms of required notice recipients, deadlines for receipt and the specific level of detail required.

Awareness of state laws providing for notice periods and recording periods for contractors and subcontractors with lien rights is critical. Contractors should gather and review every contract — upstream and downstream — to understand how they address delays, changes, notice and procedures for payment demands.

With performance and payment bonds on the job or subcontractor default insurance, contractors should start immediately exploring whether the surety will be available to help finish the work or pay for it.

Contractors, subcontractors and owners are also often required to maintain insurance portfolios, but they may not know precisely what those policies cover. On each current job, contractors must determine all of the applicable policies that may protect them. It is crucial to have internal personnel responsible for tracking outstanding accounts receivable, creating a timeline and being aware of all critical dates for notice and recording deadlines as well as statutes of limitations.

Industry participants should identify and obtain a copy of all project bonds in advance of asserting claims. In short, contractors should turn over all stones for potential payment remedies. Of course, a contractor should also be aware of any payment obligations it might have to a downstream party to avoid the unenviable situation of being unable to secure funds from an upstream source while being on the hook for payment downstream to subs and suppliers.

### **Gather Applicable Contracts and Review Closely**

Contractors are already issuing generic correspondence citing COVID-19 on project delays in order to argue timely notice and seek to avoid waiver, but many of those notices lack sufficient substance to be viable. Without substance, specific evidence and plausible demonstration of a causal relationship, these claims will be habitually rejected.

Correspondence should be timely issued with the mindset that contractors are mindful of and

sympathetic to the situation while also preparing correspondence as if it will be reviewed in depositions and in court. While it is understandable in this unprecedented time to think that a pandemic could trigger force majeure and allow for delays or missed payments, it is equally, if not more, important to analyze the specific circumstance as well as the applicable contracts before making that assumption.

As with any issue on a construction project, the initial step is to review the contract and determine all applicable provisions regarding payment and notice. Review the contract for provisions related to the payment process as well as provisions related to withholding payment from subcontractors and suppliers.

Run to ground key procedural provisions in regard to timing (when a contractor is entitled to request payment) and process (what a contractor must submit to get payment). Careful attention should be paid to any applicable dispute resolution provisions and flow-down clauses incorporating prime contract provisions between owners, architects, general contractors and other upstream parties that a contractor may lack contractual privity with.

In some circumstances, a contractor may be told that it will not be paid because of a provision in an upstream contract even if the contractor has not have received or reviewed that contract. Contractors are entitled to review any such provisions and should ask for the contracts.

Typical construction contracts have specific provisions regarding to whom and how notice is to be given. These provisions are very important to prevent a waiver argument. It is also critical to understand notice deadlines and know the triggers for when notice should be sent.

For example, if a contract pays net-30 but the contractor is told payment is not coming at net-7, on the safe side, assume potential default and send notice. Deadlines are just that — deadlines. Nothing says notice cannot be sent earlier, but be reasonable in doing so.

Contractors that lack contractual privity with the owner should know and understand their rights related to notifying the owner of a potential default. Notifying upstream is critical when possible, even if it is unclear where the delay in payment actually is. That said, some general contractors and prime subcontractors include provisions that limit parties from interfering with their upstream contracting entities unless the notice is a statutory right. Know and understand if those apply.

In regards to “pay if paid” clauses (a contractor only receives payment if the upstream party gets paid) and “pay when paid” clauses (a contractor gets paid when the upstream party gets paid), the critical distinction is that “pay when paid” clauses often do not shift the risk of nonpayment on the downstream party.

One of these clauses may allow someone to delay payment, but the upstream entity is still liable for the amount. “Pay if paid,” if enforceable, can place the risk of nonpayment on the downstream party. Both clauses should be limited to nonpayment when the receiving party is at fault for the nonpayment — upstream parties should not use these provisions as blanket excuses to avoid payment for any reason.

Several states have recently discouraged or regulated these types of clauses, so applicable state law should be reviewed to confirm whether any restrictions apply. Similar attention should be paid to clauses concerning rights in regard to insolvency and withholding.

### **Understand When and How to Pull Trigger on Lien Rights**

A lien is collateral because it gives a right to get paid from the owner's property (via a lien foreclosure). Akin to a small mortgage on the owner's property, the lien incentivizes the owner to pay out or facilitate pressure on the contractor to pay. If properly perfected, a mechanic's lien can give a contractor the ability to foreclose on a construction project if the contractor performs work but is not paid.

Perfecting a mechanic's lien is the process by which a contractor secures its interest in the project. There are two key takeaways about perfecting mechanic's liens: (1) they are governed by state law and almost every state has its own variances; and (2) the procedure to perfect one is often time-sensitive.

Contractors should retain an experienced attorney for securing lien rights unless they are familiar with the relevant state's process. An extended cessation of work may trigger lien filing deadlines. For example, in some jurisdictions, if all labor stops on a private project for 60 consecutive days, it constitutes a completion equivalent, triggering the deadlines to file liens.

Lien rights are mission-critical for lower-tier subcontractors that lack contractual privity with the owner. It is often the only way to force an owner to make payment in the event any upstream party becomes insolvent or cannot make payment. Some states require notice before starting work, and some states require specific notices to specific parties at certain times in order to secure a lien. Texas, for example, is incredibly complicated.

Pay attention to details, be aware of critical deadlines and leave ample time. Many states typically require sworn affidavits that can be cumbersome to prepare, execute and serve on short notice — especially in the current shelter-in-place climate. Additionally, many courts are closed and many county clerk offices are closed, and open clerk's offices may be experiencing delays processing liens.

These delays could result in a timely delivered lien being held unenforceable because it was not received timely by the clerk due to COVID-19 operational delays. As a result, personal filing or e-filing is the best alternative if possible. And always (always, always) keep all records related to lien filings and recordings.

### **Look to Payment Bonds**

Payment bonds on a project are similar to liens, but instead of securing a foreclosable interest in the property, a contractor can secure a claim against a bond sold to the owner or general contractor of a project. Because payment bonds are creatures of contract (i.e., purchased by an owner or contractor) they do not exist on every project, but they are beneficial to a downstream party if available. Bonding companies can release the amount a contractor is owed if the bond is secure, usually with any attorney's fees incurred in securing the claim.

All government projects have bonds in place — after all, a private contractor cannot sell a public building — and almost all government projects require a bond to secure payment of downstream parties. Payment bonds are also becoming more common on larger complex projects to ensure that payment problems do not interfere with ownership rights of the project.

Like liens, payment bonds have a specific procedure to follow to secure a claim on the bond. Contractors should review and analyze the bond and confirm applicable state and federal law for specific requirements, paying particular attention to when and to whom notice must be given. Most states have laws obligating the bond holder to provide the bond to a downstream party and it is often recorded in the real property records. If initiating a lawsuit, suit should be brought against both the bonding

company and principal on bond.

While this article focuses on means to secure payment by timely giving applicable notices from contracts, liens or bonds, of equal import is the thorough, documented preparation of a response for companies on the other end. For recipients of a notice of nonpayment or lien claim or responses from an upstream entity that dispute entitlement to payment, the issuance of a detailed written response is critical.

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[1] SAL Electric Co. Inc. v. The Pike Co. Inc. et al., case numbers A-5657-18T1 and A-5658-18T1, in the Superior Court of New Jersey, Appellate Division.

[2] See, e.g. In re Bigler LP, 458 BR 345, 373 (S.D. Tex., Houston Division 2011).