

## One question: Where did all the money go?

Building owners can take steps to protect themselves from construction liens during a down economy



### LEGAL EASE

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“Where did all the money go?” Lately, this question has been on the minds of many building owners who pay general contractors expecting they will use those funds to pay their subcontractors and suppliers

for work done on projects. These days, owners have less reason to assume the funds will get there.

Given these trying economic times, it appears some overextended and cash-strapped general contractors may be using money received for current project work to pay off subcontractors for work on previous or concurrent projects. As a result, unpaid subcontractors turn to lien laws that protect them from nonpayment. And if worse comes to worst, the owner could end up paying twice for the same work: once to the general contractor and a second time to the unpaid subcontractor. Even worse, the owner's property may be foreclosed in the process and sold off to satisfy the debt. This presents a potential double-whammy, leaving an owner to defend expensive and time-consuming lawsuits while its project (or investment) is stalled or terminated.

In a nutshell, construction liens are like security interests created by statute as a vehicle to help contractors get paid for work completed on privately-owned projects. Provided an unpaid contractor strictly complies with all notice and timing requirements, it may file a claim of lien (in essence, a formal “heads-up” to inform the owner of a payment issue), followed by a lawsuit to enforce the lien. If the case is not settled, the property is sold and the proceeds from the sale are used to satisfy amounts due the contractor.

How can an owner ensure that the money it pays the general contractor will reach the appropriate subcontractor? It can't. But there are steps an owner can take to reduce the risk of exposure to lien and other claims filed by subcontractors on projects. A little due diligence, some awareness and a well-drafted prime contract addressing the following issues go a long way toward achieving that goal.

1. Know the subcontractors. Keep track of the trade contractors who should receive money from the general contractor by including a provision requiring the general contractor to either identify any desired subcontractor or seek the owner's approval of any proposed subcontractor. If your general contractor terminates a subcontractor or enters into multiple subcontracts for the same trade, this should raise a red flag that payment issues are on the horizon. Of course, confirm whether the general contractor is reliable and has the resources to do a job before awarding the project.

2. Notice of claims, offsets and indemnification. Include a provision requiring the general contractor to notify the owner of any claims made. Early notice of claims is crucial for the owner to protect itself by, among other things, withholding payment to the general contractor. Also provide for an owner's right to offset, back-charge and/or withhold payments under these circumstances when subcontractor claims surface. Another form of protection is a broad indemnification

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provision that requires the general contractor to defend and hold the owner harmless from third party claims. Finally, the general contractor should be required to promptly bond-off any filed liens.

3. Lien waivers. Require the general contractor and subcontractors to execute broad lien waivers as part of the payment application process. Owners should take special care to prepare appropriate language for lien and claim waivers, which should, among other things, require: the general contractor to affirm that it has paid its subcontractors from amounts previously paid by the owner, and the subcontractor to affirm that it has been paid out of amounts paid to the general contractor. Properly drafted lien waivers constitute persuasive evidence for courts considering the dismissal of lien claims.

4. Direct payment to subcontractors. Reserve the right to make payments directly to subcontractors. This is effective because liens are discharged to the extent the debt has been paid. Frequently, owners will issue joint checks to the general contractor and the subcontractor when payment issues surface. While attractive in theory, this concept of dual payment has its own risks, whereby the general contractor might misappropriate the money after endorsement by the subcontractor, thus still leaving the subcontractor unpaid. Issuing joint checks also raises other contractual (so-called third-party beneficiary) issues, which could expose the owner to direct claims from the subcontractor.

5. Payment bonds. Require the general contractor to procure a payment bond, whereby a surety is charged with handling lien and other claims that are unpaid by the general contractor. While the payment bond does not automatically discharge a lien, it indemnifies the owner against claims in the event of a default by the general contractor. It goes without saying that a general contractor would be in default for using funds received from the owner to pay off subs on other projects.

Most experienced construction lawyers will acknowledge that there is no such thing as a fool-proof construction contract for any project. However, owners will be best positioned to limit their exposure to lien and other claims if they: first, have a favorable contract that they understand and enforce; and second, stay actively involved in the project on a day-to-day basis to recognize and address payment issues as soon as they surface.

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