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TRENDS IN PROMPT PAYMENT ACTS GOVERNING PRIVATE CONSTRUCTION CONTRACTS

Prompt Payment Acts ("PPAs"), which the federal government and many states have enacted, generally provide legal recourse against owners or contractors who fail to meet payment obligations required by construction contracts. The number of PPAs governing private construction contracts is on the rise, and in the past year several amendments to such PPAs went into effect in Delaware, Oregon, and California. Additionally, new legislation was introduced in Nebraska and Colorado in January. This area of the law is in flux, and case law is sparse due to the recent enactment and amendment of many of these private PPAs. However, a number of important trends are developing across the United States. This *Commentary* addresses the rise of private PPAs, how PPA statutes work, and notable trends in drafting and executing construction contracts.

THE RISE OF PRIVATE PPAs

The first PPAs governed contracts with public entities. More than 30 years ago, Congress drafted legislation mandating prompt payment in contracts with the federal government. Known as the Prompt Payment Act of 1982, Pub. L. No. 97-177, 31 U.S.C. §§ 3901 *et seq.*, the law entitles contractors to recover interest at a set rate if, upon proper notice, the federal government fails to make timely payment.[1] It also requires contractors to make prompt payment to subcontractors.[2] In 1988, the law was amended to include specific provisions relating to construction contracts.[3] These provisions set out time limits, interest rates, and other restrictions on construction contracts and payment, including the mandate that contractors must pay interest on any amount that they have been paid but have failed to earn due to deficient performance.[4]

1 *See* David W. Burgett & Edward C. Eich, "Contrasting CBCA and COFC Decisions Illustrate What 'Disputes' Will Toll the Accrual of Prompt Payment Act Interest," Bloomberg L. Fed. Contracts Rep. , May 2009.
2 31 U.S.C. § 3903.
3 *See id.* § 3905.
4 John W. Hays, "Prompt Payment Acts: Recent Developments and Trends," 22 Constr. Law. 29, 29 (2002).

Following the passage of the federal PPA, many states began to follow suit with their own versions of PPAs.[5] PPAs governing public contracts were enacted quickly and have been in place in 49 of the 50 states for well over a decade. However, PPAs governing private contracts are continuing to gain steam. Today, two-thirds of the states have enacted a PPA governing private contracts, and states are continuing to revise and develop the statutes they have recently enacted.

The American Subcontractors Association ("ASA") has been especially active in lobbying states for the passage of PPAs, based on concerns that subcontractors are not privy to negotiations between the owner and prime contractor, that they might bear the risk of owner nonpayment, and that subcontractors often have to wait a lengthy period of time before suspending work based on nonpayment.[6] The ASA's efforts convinced several states to legislate or to judicially recognize that contractual clauses shifting the burden of nonpayment to subcontractors are void as a matter of public policy.[7] Other states included limitations on such clauses within their PPAs, or have otherwise employed PPAs to address some of these concerns.

HOW PRIVATE PPA STATUTES WORK

Private PPA statutes are anything but uniform, but they share some common components, which generally set forth penalties for late payments in certain contractual situations. Every PPA statute is unique in its requirements and applicability, so in any given contract scenario, potentially applicable PPA statutes should be closely scrutinized.

At its outset, a PPA statute generally defines the parties and situations to which it applies. Private PPA statutes usually apply to contracts for the improvement of land (including everything from demolition to construction), and PPA purpose statements tend to reflect the states' interest in the economic stability and viability of the construction industry. Generally, PPA statutes identify the contractual situations in which they apply, such as to disputes between the owner and contractor or, more frequently, to disputes between contractor and subcontractor.

There are also requirements for invoicing, payment deadlines, and interest rates on overdue payments. PPAs usually include standards or events to trigger the date upon which the invoicing party is entitled to payment. From that date, PPAs impose a deadline—usually an exact number of days—for payment. The contracting entity may get a certain period of time to respond to any payment requests, but otherwise, if payment is not made by the statutory deadline, the contracting entity must pay the contractor or subcontractor overdue payments plus a statutory rate of interest.

Additionally, PPAs often include provisions that limit certain industry procedures and practices. Most commonly, PPAs place parameters on parties' actions, from invoicing and notice procedures to retainage practices. Many PPAs also limit parties' ability to override PPA provisions by contract.

Finally, PPAs almost always set an interest rate that will be applied to overdue payments. Private PPAs often treat the statutory interest rate as a default and allow parties to contractually agree to another (usually lower) rate. A few states also impose additional penalties. For example, Oregon's PPA provides for civil penalties or sanctions, or even termination of a contractor's license for repeat offenses.[8]

NOTABLE PRIVATE PPA TRENDS

APPLICABILITY TO DESIGN PROFESSIONALS AND OTHERS

Most PPAs were initially targeted primarily at building contracts, but it is increasingly common for PPAs to apply to other related contracts and services. Some statutes broadly include contracts for professional or skilled services, and others specifically include architectural, engineering, financial, design, or even medical services that are related to construction or land improvement contracts. Delaware became the most recent state to adopt this broad

5 Frank Hughes & Debera Massahos, "Statutes Permitting Recovery of Attorney's Fees in Construction Cases," 17 Constr. Law. 33 (1997).
6 Edward H. Tricker, Kory D. George, and Erin L. Gerdes, "Survey of Prompt Pay Statutes," 3(1) J. Am. C. Constr. L. 5 (Winter 2009).
7 Richard A. Lord, 8 Williston on Contracts § 19:59, nn. 1-7 and accompanying text (4th ed.).
8 Or. Rev. Stat. § 701.992.

application. Previously, its PPA applied to contracts "to furnish labor or materials" in connection with construction or land improvement projects,[9] but after a 2012 amendment, Delaware's PPA also applies to contracts to furnish related services, and it includes in its definition contracts with "architects, engineers, surveyors, construction managers, and all persons providing … services in connection with" such projects.[10] Interestingly, private PPAs have generally adopted broader definitions of covered services or contracts than public PPAs.

EXCLUSION OF SMALL, RESIDENTIAL PROJECTS

Some private PPAs cover any and all construction-related private contracts, but more commonly, PPAs exclude smaller contracts from coverage. The extent of exclusions are varied. The most common exclusion is for single-family residential units or projects involving a limited number of residential units. Some states exclude projects on owner-occupied property, and at the other end of the spectrum, some states exclude projects by residential homebuilders. PPAs also commonly exclude certain projects below a specified dollar amount, ranging from projects valued at under $1,000 where no building permit is necessary (Hawaii) to projects valued at under $3 million (Massachusetts).[11] Some PPAs make exceptions for certain situations, such as a lender's failure to properly disburse funds. Additionally, there are a few industry- and region-specific exclusions, such as contracts for oil and mineral production and development (Texas), or contracts related to land improvement in lower Manhattan necessitated by the 9/11 terrorist attacks (New York).[12]

PROHIBITION OF CERTAIN COMMON CONSTRUCTION CONTRACT PROVISIONS

Private PPAs often make certain contractual provisions void and unenforceable. Some state that a contract cannot override parties' rights under the PPA, and others refer to specific provisions that are unwaivable. For example, Colorado's proposed legislation declares that "any provision in a construction agreement that sets payment terms in violation of this article is unenforceable and void as against public policy."[13] The three most commonly prohibited clauses are "no damage for delay" clauses, "pay if paid" clauses, and choice of law or venue clauses.

"No Damage for Delay" Clauses. "No damage for delay" clauses are often included in construction contracts to ensure that the owner will not have to pay damages to the contractor (nor the contractor to the subcontractor) if work is delayed for certain reasons. These clauses are generally permitted, although a few PPAs prohibit such clauses outright, and a few others allow such clauses on a limited basis. For example, such a clause might be permitted only to the extent that the cause of the delay is an act of God or is otherwise outside the control of the contracting entity, or to the extent that the contractor hired by the contracting entity is responsible for causing the delay. Some PPAs also require parties to notify each other of any foreseeable delays.

"Pay if Paid" Clauses. A few PPAs prohibit "pay if paid" clauses, which contractors often include in contracts to ensure that if they are not paid by an owner for work on a project, they will not be required to pay subcontractors out of their own pockets. Even in the absence of a statutory prohibition, some courts have found "pay if paid" clauses to be void as a matter of public policy. Prohibitions on such clauses effectively place the entire risk of owner nonpayment on the shoulders of the contractor, requiring contractors to foot the bill for the owner's construction project unless and until the owner pays.

Choice of Law or Venue Clauses. It is increasingly common for PPAs to state that in contracts for the improvement of land, choice of law or choice of venue provisions in favor of other states' laws or venues are unenforceable or void. Delaware was one of the latest states to include such a prohibition, using sweeping language to declare that no dispute governed by the PPA may be resolved in or under the laws of another state.[14] Notably, however, the Federal Arbitration

9 Del. Code Ann. tit. 6, § 3501 (2011).
10 78 Del. Laws 269, § 1 (2012) (amending Del. Code Ann. tit. 6, § 3501, *et seq.*).
11 Haw. Rev. Stat. § 444-2; Mass. Gen. Laws ch. 149, § 29E.
12 Tex. Prop. Code Ann. § 28.010; N.Y. Gen. Bus. Law § 756-e.
13 H.B. 13-1090, 69th Leg., 1st Sess., at § 8-10.5-110 (Colo. 2013)
14 78 Del. Laws 269, § 1 (amending Del. Code Ann. tit. 6, § 3503).

Act likely preempts laws prohibiting parties from arbitrating in another state.[15]

SUSPENDING PERFORMANCE AND WITHHOLDING PAYMENT

PPAs tend to be more permissive in allowing a contractor or subcontractor to suspend performance than in allowing an owner or contractor to withhold payment. Most PPAs allow parties to suspend performance if they are not promptly paid. However, many PPAs require that parties meet certain notice requirements before suspending performance, and a few also require that the payment must be undisputed.

In contrast, many PPAs set forth specific grounds upon which the withholding of payment will be justified. Sometimes these provisions are expansive, giving the owner or contractor broad justification for withholding funds in a variety of circumstances, but often the provisions are rather restrictive, appearing to limit the circumstances under which an owner or contractor might otherwise arguably withhold payment. Permissible grounds for withholding payment enumerated in some PPAs include: unsatisfactory performance, failure to comply with the terms of the contract, defective construction or damage, evidence that construction will not be timely or fully completed, the filing of third-party claims, or the failure of the contractor or subcontractor to timely pay his or her obligations to lower-tier contractors. PPA provisions regarding the withholding of payment generally include notice requirements, and they may also require that the payment must be withheld in good faith or that the dispute must be bona fide. Some statutes also impose a limit on the amount that may be withheld, such as an amount not exceeding a certain percentage of the disputed amount.

EXTRA PROTECTIONS FOR SUBCONTRACTORS

In general, PPAs tend to be especially protective of subcontractors and lower-tier contractors. Some states' private PPAs apply only to contracts between contractors and subcontractors, and not to contracts between owners and contractors. To the extent that the latter type of contract is covered, PPAs sometimes require that owners may or must withhold payment to contractors until contractors have made timely payments to subcontractors. Additionally, PPAs often mandate short deadlines for payment or restrict contractors' ability to retain funds or alter PPA provisions by contract. In contrast, provisions for payment to prime contractors tend to provide default deadlines and other provisions, which a contract may override. Finally, some PPAs set forth limitations that are unwaivable, such as those discussed above, in order to provide extra protection for subcontractors. These distinctions based on type of relationship are likely a result of perceived differences in resources and bargaining power, and they may be due to the role of the ASA in lobbying for the passage of PPAs.

AWARDS OF ATTORNEYS' FEES AND COSTS

Many states allow for recovery of attorneys' fees or costs. Some PPAs that provide for attorneys' fees might not allow parties to override or amend the provisions by contract. However, where PPAs lack an express provision addressing attorneys' fees, or fail to define related terms, courts are often willing to enforce contractual fee- and cost-shifting provisions.

Fee and cost-shifting provisions under the PPA each set forth a standard that must be met in order for a party to obtain attorneys' fees and costs. Some standards are set very high, requiring the court to make a finding of bad faith. At the other end of the spectrum, it is common to find provisions awarding attorneys' fees to the successful or prevailing party: Iowa merely requires a party to show that it has "established a claim."[16] Other PPAs require something in between. For example, Maine requires that a party must substantially prevail and prohibits contractual provisions to the contrary.[17] Interestingly, the standards applicable to public contracts are often higher than those applicable to private contracts.

Many jurisdictions have yet to develop case law regarding the interpretation and application of these standards in the PPA context. However, a Louisiana appeals court found that a contracting entity's unjust refusal to pay funds clearly

15 *See* Robert A. Prentice *et al.*, *Pennsylvania Construction Law: Getting Started, Getting Covered, Getting Paid* 136 (2010).
16 Iowa Code § 573.21.
17 Me. Rev. Stat. Ann. tit. 10, § 1118(*4*).

owed constituted bad faith under the applicable PPA.[18] The standards have often proven to be somewhat malleable in the hands of the courts. For instance, the Vermont Supreme Court recently ruled that a contracting entity "substantially prevailed" in defending against a contractor's claims, despite the fact that the contractor was the "net victor to the tune of [a few hundred dollars]."[19] In another PPA case, a Texas appeals court ruled that a party that did not prevail on all claims could still potentially recover fees on its PPA claim if it properly segregated its recoverable fees attributable to the claims upon which it prevailed.[20]

Whether an award of fees and costs is available may also depend upon the basis for the claim or upon where the dispute is heard. For example, Oregon recently limited fee and cost awards to the prevailing party in actions to collect interest.[21] PPAs may also limit awards to a dispute determined by a court (rather than arbitrators), or vice versa.

Finally, even if the standard is met, fee and cost provisions are not always mandatory. Many provisions—including one in Nebraska's proposed legislation[22]—automatically entitle a party to recover reasonable fees and costs, but others are permissible, allowing the court to determine whether to make such an award.

GREATER FREEDOM OF CONTRACT THAN PUBLIC PPAs

Despite the many requirements in today's private PPAs, private PPAs are more likely to allow parties to override certain contractual provisions by agreement, unlike public PPAs, which tend to set rigid provisions that may not be altered by contract. A few states allow private contracts to override all or almost all provisions of the PPA. However, provisions that are most frequently subject to override in private contracts include: requirements on invoicing, notice, deadlines, retainage, grounds for withholding payment, and substantial performance. Thus, in many states, these provisions serve as default gap-filler provisions rather than mandates.

CONCLUSION

Now that most states have enacted private PPAs, owners, contractors, subcontractors, and design professionals should be aware of PPAs' effect on the contractual relationship and payment obligations on construction projects. Each state varies, but some of the more common provisions in construction contracts could be void as a matter of public policy or overridden by a private PPA. Furthermore, private PPAs may provide additional remedies to contractors or subcontractors that increase the financial risk to owners or contractors. Experienced, creative, and practical counsel can assist owners, contractors, subcontractors, or design professionals in evaluating and mitigating their contractual risk on construction projects in any state in light of the increase of private PPAs.

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18 M. *Matt Durand, L.L.C. v. Denton-James, L.L.C*, No. 2011 CA 0784, 2012 WL 762303, *5 (La. Ct. App. Mar. 8, 2012).
19 *Burton v. Jeremiah Beach Parker Restoration & Constr. Mgmt. Corp.*, 6 A.3d 38, 42 (Vt. 2010).
20 *AMX Enters. v. Master Realty Corp.*, 283 S.W.3d 506, 521 (Tex. Ct. App. 2009).
21 2011 Or. Laws 553, § 1 (amending Or. Rev. Stat. §§ 701.620 – 701.645; effective Jan. 1, 2012 as per Or. Rev. Stat. §171.022).
22 L.B. 373, 103rd Leg., 1st Sess. (Neb. 2013).