Getting Paid:
Entering, Negotiating and Enforcing Construction Contracts

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I. INTRODUCTION

Getting paid for work performed or materials provided should be automatic. Unfortunately, it often is not. Owners run short of funds, less scrupulous contractors try to squeeze profits out of subcontractors and when trouble occurs on a project, blame flows downhill. Confronted with this ugly side of the human condition, we must still get on with it. Contractors, subcontractors and material suppliers must do what they can to ensure that they are paid for work they perform and materials they supply.

While there are many things you cannot control, there are proactive actions you can take to make payment more likely. In a nutshell, know who you are dealing with, know the terms of the agreements you sign, and where possible, change those terms to your benefit. Once you begin work, scrupulously comply with the 20-day notice requirements, actively document your work, make your views known when disputes are brewing and observe the procedural requirements for filing claims. If a pay dispute does occur, use the substantial leverage the law gives you to protect your rights.

Of course, there are no guarantees, and there may be times when you need to file suit to be paid. Nevertheless, if you have managed these steps properly, not only is it more likely that you will have avoided lawsuits, your chance of prevailing in a lawsuit will be enhanced.

II. PRELIMINARY CONSIDERATIONS: BE SURE YOU ARE DEALING WITH THE RIGHT PEOPLE

a. Know who you are dealing with.

Before you bid a large job for someone you don't know, find out who you are dealing with. Ask people you know in the industry about the contractor. Check the Contractors State License Board to see if the contractor's license is current and in good standing. If the contractor is local, look at the local court website to see if their name appears as a defendant in civil actions. If the firm contracts in many counties, ask an attorney or investigator to run a Lexis/Nexis search to find out if they have a substantial history of being sued. If it is a big enough job, it may be worthwhile to run a Dun & Bradstreet check on the firm.

b. Be licensed and work with licensed contractors.

No license, no pay: Business and Professions Code section 7031. Under the old law, an unlicensed contractor who performed work under a contract could not sue to enforce his or her right to payment under the contract. Under the new law, an unlicensed contractor who has been paid can be sued to <u>return</u> the money. Such a contractor is at great risk. This rule may apply even if the contractor was licensed at the time of the contract and simply lost his or her license by "innocent" oversight during the time he or she is performing the contract.

What if the contractor is licensed and the subcontractor is not? The licensed contractor can be subject to civil penalties and discipline. Business and Professions Code section 7118 provides that entering into a contract with an unlicensed person or entity constitutes grounds for discipline of the contractor by the Contractors State License Board.

Moreover, a licensed contractor who willingly and knowingly enters into a contract with an unlicensed person or entity to perform services requiring a license under the contractors' state license law is subject to a civil penalty of $100 per day for each such contract with an unlicensed person. Labor Code section 1021.5. Thus, it is important to make a reasonable investigation into the licensing status of the parties one contracts with. In *Wang vs. Division of Labor Standards Enforcement* (1990) 219 Cal.App.3d 1152, 268 CR 669, the court held that Labor Code section 1021.5 requires proof that at the time of entering into the subcontract, the general contractor knew that the contractor was unlicensed. However, the court found that a contractor's failure to make reasonable efforts to verify the licensed status of a subcontractor can support the inference that the contractor actually knew that the subcontractor was unlicensed.

Additionally, the owner can withhold the amount due to the contactor for the work of the unlicensed subcontractor. In *Holm v. Bramwell* (1937) 20 Cal.App.2d 332, 67 P.2d 114, plaintiff, a licensed contractor, contracted with an unlicensed subcontractor paying him $1,108.63. Plaintiff sued the owner for the balance due on his cost-plus contract. The court of appeal found that the plaintiff was not entitled to recover the $1,108.63 because the agreement with the unlicensed subcontractor violated the contractors' state license law.

One final item. If a contractor hires an unlicensed subcontractor, the employees of the subcontractor can become the employees of the licensed contractor for workers compensation purposes.

The bottom line is this: Be licensed, only work for licensed contractors and hire only licensed subcontractors.

III. NEGOTIATING CONTRACTS

Subcontractors often contend that they have no bargaining power and no ability to modify the contracts offered by contractors. There is some truth to this, but it is by no means a hard and fast rule. Sophisticated contractors and subcontracts can and do succeed in changing the terms of the contracts into which they enter. Contractors and subcontractors who do this can improve their ability to collect under their contracts.

a. Be sure you know the documents which form your contract.

Most construction contracts involve form agreements of varying length and some are quite long.[1] One would hope that the length of these agreements would enable the parties to make their intentions explicit. But this is not always the case. Their length can be due to inartful drafting, and the careless combination of various forms. This can sometimes lead to agreements with clauses that are at odds with each other. Normally, jobs go smoothly, and the contradictory terms are never tested, but when problems arise, the contract can sometimes contribute to conflict, rather than aid resolution.

Contract terms are often found in several documents, including, potentially the bid solicitations and acceptances, a short "contract,"

[1] Not all contracts are written. Contracts may be made on a handshake or less. Such contracts can be enforceable, especially if work under the contract has begun. Nevertheless, contractors and subcontractors have an obligation to have contracts that conform with licensing law. Handshake agreements are thus done at one's peril.

general and special conditions, drawings, details, addenda, etc. These are often itemized in a separate attachment. These documents collectively form the contract and may modify each other. For example, when a contractor accepts a subcontractor's bid, and the bid contains terms not found in the original subcontract, terms from both the subcontract and the bid may be incorporated in the agreement. Contracts can also be modified as the project unfolds through formal change orders, correspondence, drawings and verbal and written directions

Subcontractors may include new contract terms through several means, including proposals for change orders, purchase orders, concrete truck tickets and bills of lading. A good example of such terms being incorporated into a contract can be seen in the case of *Marin Storage & Trucking, Inc. v. Benco Contracting and Engineering, Inc.* (2001) 89 Cal.App.4th 1042, where an employee of a subcontractor on a construction project was injured in an accident involving a crane supplied for use on a project by a crane company. The employee sued the crane company and the general contractor. The crane company argued that the contractor's foreman had signed a "work authorization and contract" which, in addition to setting out the number of hours the crane had operated, contained a Type 1 indemnity clause, set out in fine print.[2] The court of appeal enforced the agreement because, althought the agreement was clearly a "contract of adhesion," the court did not consider the contract to be "substantively unconscionable."

[2] Type 1 and Type 2 indemnity clauses are discussed below and defined in the Glossary at the end.

To further complicate matters for subcontractors and material suppliers, subcontracts and material supply agreements may incorporate all or portions of the prime or general contract agreements by reference. When they do, subcontract and material supply agreements may conflict with the prime or general contracts.

All of these documents may affect the potential procedures and remedies available in the event of a dispute between parties. Since the goal is to get paid, it is well worth one's time to pay attention to those elements of these agreements that can facilitate or hinder recovery.

b. Be aware that contracts may contain both express and implied terms.

Construction contracts come in all shapes and sizes. Express contract terms are those that are spelled out in the documents comprising the contract. Implied terms are terms that courts "read into" contracts, whether they are written or not. No contract contains express terms covering all potential pitfalls the parties may encounter. The result is that implied terms may be needed to clarify the rights and duties of parties to the contract.

There are many types of implied terms. For example there are implied warranties, such as the material supplier's warranty that a manufactured item is fit for its intended use, the contractor's implied warranty of workmanship and the owner's implied warranty that his drawings are constructible. There are also various rights of contractors that are implied in law, such as stop notice and mechanic's lien rights.

There are also more obscure implied terms as well. Interest on late payments is a good example. Some contracts may expressly provide

specific interest rates for late payments. Caltrans, for example, provides in its special provisions that where claims are brought to arbitration, interest on the amount owing accrues at 6% per year. This is a relatively low interest rate. When contractors draft contracts, they might put in a much higher interest rate and an 18% interest rate is not uncommon. These are express contract terms.

But if the contract is silent as to the interest rate on late payments, does any interest accrue? In some circumstances, the answer is yes. Specifically, if a suit is filed and judgment entered, interest will accrue on the late payment at an annual rate of 10% simple interest, pursuant to Civil Code section 3289. Moreover, if an owner or contractor has withheld progress payments or retention when there is no bona fide dispute as to the contractor or subcontractor's right to payment, there may be an additional 18% penalty added to this interest.

These are just a few examples of what we might consider to be implied contract terms. They are relevant because contracts often contain very few material terms, and where terms are omitted, the implied terms fill the gaps in the contract. Some of these implied terms can be written out of contracts, such as the prejudgment interest rate, and some cannot, such as the penalty for late progress and retention payments.

c. Be aware that boilerplate agreements may be modified by handwritten terms and strikethroughs.

Construction contracts are usually are written with a large amount of "boilerplate," i.e. pre-printed terms and conditions. Sometimes these provisions are at odds with the actual intentions of the parties. If the

parties do not signal that they have contrary intentions, these boilerplate terms govern the contract and its interpretation. This is especially true when a contract has an "integration clause" which sets out that the contract is controlling and contains all of the agreed terms, even if there were contrary positions taken during negotiation of the agreement.

Where one's agreement conflicts with boilerplate provisions in a contract, it is important to cross out those portions of the boilerplate one objects to. One may also handwrite or type in terms that one wishes to see in the contract.[3] If the handwritten or the manually typed portions of a contract conflict with the "boilerplate," courts will generally enforce the changes as reflecting the actual intent of the parties and ignore conflicting portions of the pre-printed form.

d. Be familiar with rules of offer and acceptance.

Generally, contracts are formed where there is an offer and an acceptance of the offer. What constitutes acceptance? In its simplest form, acceptance occurs when one agrees to all the terms of an offer with no changes.

If one "accepts" an offer with the proviso that certain material terms of the offer be changed, it is not considered an acceptance, and is instead a counter-offer. The understanding is that a counter-offer destroys the offer, i.e. once a counter-offer is made, the offer is no longer on the table.

If one accepts an offer with the proviso that a few immaterial terms be added or modified, this <u>may</u> constitute an acceptance. It does if the

[3] These changes to the boilerplate should be initialed by all parties to show that they have been agreed to.

contract is one for the supply of materials. Even if it is for services, it can constitute either an acceptance or an accepted counter-offer if the parties then proceed as though a contract has been formed.

A party can use this approach to contract formation to his or her advantage. Bids and written acceptances can be used to insert "immaterial" terms that are helpful to the accepting party.

e. Be aware that integration clauses may complicate one's ability to refer to other documents to modify or clarify the meaning of a contract.

Courts may be willing to impose new or contradictory terms to an agreement through reference to other documents, such as a bid or acceptance. To avoid this result, parties sometimes put an integration clause in a contract. Integration clauses essentially tell the Court that the contract itself contains all the terms of the agreement, regardless of whatever evidence there is to the contrary. Integration clauses may make the use of some of the strategies described above more complicated and less sure.

IV. REVIEWING CONTRACT TERMS: ENSURE THAT THE CONTRACT COVERS COLLECTION ISSUES

a. Ensure that the contract properly specifies your scope of work.

Subcontractors must be sure to clearly state what work they will and will not do under the contract. If there is work commonly excluded, or which requires the assistance of the general contractor, make sure that this is properly set out in the bid or acceptance and that the bid or acceptance is incorporated by reference into the contract.

b. Ensure that the contract addresses when and on what terms you are to be paid.

1. Spell out provisions for progress payments

Contracts should address payment intervals. For example, they should establish whether payments are expected on time intervals, such as monthly pay applications and payments, or whether payments should be based on the completion of a certain percentages of work or milestones. It is also helpful to spell out that payment is due when large quantities of materials have been purchased. There should be a deadline for payment after the milestone has been achieved. It is also a good idea to set out a schedule of contract values in the contract, e.g. $20,000 for plumbing, $17,000 for framing, $20,000 for roofing, etc.

2. Negotiate and spell out provisions for retention

Most contracts provide for retention, but it is not required. The intent of retention is to prevent subcontractors from becoming "upside down" on the job and to provide the owner for some protection from shoddy work. The amount of retention is not set by law. Some may say that there is an industry standard of 10%, but this is certainly negotiable. It is also possible to negotiate a reduction in the retention as the job nears completion.

It is also important to address how long retention can be held. Traditionally, retention is held 35 days after completion of work. This is based on a 30-day limit to file a mechanic's lien. It gives the owner or lender 5 days to have a title company examine title at the County Recorder's office.

3. Avoid "Pay when paid" clauses

"Pay if paid" clauses are illegal. "Pay when paid" are enforceable to an extent. Pay when paid clauses may not be used to interfere with a subcontractor's right to assert mechanic's liens and bond claims. If the owner does not pay the contractor, he may not wait indefinitely and make good on his obligations to a subcontractor.

If the subcontract contains a pay when paid clause, the subcontractor may want to have contract terms allowing it to cease work if payment is not forthcoming.

4. Be aware that prompt payment waivers are void and unenforceable

Business & Professions Code section 7108.5 provides that a prime contractor must pay the subcontractor within 10 days of payment by the owner. The penalty for non-compliance is 2% per month plus court costs and attorney's fees. These "implied in law" terms cannot be waived in a contract. If a clause in a contract purports to do so, it is invalid.

c. Be aware of clauses addressing changes to work.

Ensure that your contract spells out a procedure for change orders and take note of it. Be prepared to follow it and document your work.

1. Understand the impact of clauses requiring that all changes be made in writing

It is important to ensure that nearly all contracts require change orders to be in writing. When an owner or contractor directs that work be done, get the order in writing.

Nevertheless, even where the contract specifies that all changes must be in writing prior to the performance of the work, the contractor or owner often waives this by insisting on action at verbal direction. A judge or arbitrator may refuse to enforce the requirement for written change orders if he or she determines that the requirement was waived by the contractor's action.

Whether or not a written change order is issued, if one can prove that a change was performed at the direction of the owner or contractor, the one will have a substantial chance of prevailing at a hearing. The lack of written direction makes this proof more difficult to provide, but it

can be done. Thus, at a minimum, it is important to train your field staff to document the extra work with contemporaneous letters to the owner or contractor and notes in daily logs. If possible, have the owner or contractor sign off on tickets acknowledging that the disputed extra work was performed.

2. Include clauses spelling out overhead and profit calculations for change orders

One helpful issue to address in contracts is the extent to which overhead and profit is allowed on changes. Disagreement over this is a source of some tension. When negotiating these clauses consider: Does the overhead rate adequately address home office overhead, site overhead and the costs of administering the change. Does overhead include the use of owned equipment? If not, how will the value of that equipment be considered. In calculating overhead, it is useful to be able to take advantage of the Caltrans Manual for Costing Owned Equipment.

d. Be conscious of clauses related to the filing of claims.

Contractors must carefully observe clauses related to claims. The filing of claims is often used as a backdoor way of obtaining an "equitable change order" where a written change order was denied, or never obtained.

The contractor or subcontractor should begin by determining whether there are substantive limitations to claims, the most common being "no damage for delay" clauses, which allow time extensions, but no monetary compensation for damages resulting from delays. "No damage

for delay" clauses are generally enforceable, but courts may balk at enforcing them if the owner is the cause of the delay.

Next determine the procedures for filing claims. These can be tricky because the time for filing claims is generally very short. The Associated General Conractors of California's (AGC) short form subcontract actually provides that the subcontractor must give notice of a claim before he does any work related to the chosen item.[4] The AGC writes a friendlier claim clause for contractors, providing that the notice only be made in a "reasonable" time frame.[5]

Commonly, courts overlook these short periods of time, but not always. Courts may consider the time frames to be an essential part of the contractor's obligation to "exhaust administrative remedies." Under this line of analysis, the court essentially loses jurisdiction over the claim unless the claim is exhausted, i.e. filed and pursued under the procedures listed in the contract.

The exhaustion of administrative remedies doctrine applies to more than just the timely filing of a claim. It also applies to the pursuit of the claim. If the claim is required to be brought before an architect or a board of review, these avenues should be pursued, lest the claim be lost for failure to exhaust.

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[4] It states: "Claims: If any dispute shall arise between Contractor and Subcontractor regarding performance of the work, or any alleged change in the work, Subcontractor shall timely perform the disputed work and shall give written notice of a claim for additional compensation for the work prior to commencement of the disputed work and give prompt notice of any defect therein."

[5] The Standard Form Prime Contract Between Owner and Contractor provides "Subject to the provisions of Article 15, the Contractor shall give to the Owner written notice within a reasonable time after the happening of any event which the Contractor believes may give rise to a claim for an equitable adjustment in the Contract Price or the Contract Time."

What period of time is "reasonable" might be determined by the clause which follows, providing that "no claim shall be allowed if asserted after final payment under this contract."

The exhaustion of administrative remedies doctrine has some advantages, since it may provide a means to resolve conflicts during the course of the project, in a quick and cost-effective manner. On the other hand, it can impair a contractor's right to pursue his claim in arbitration or court because the decision of the architect or board of review may be given great deference in a court. In some cases, courts have actually found that the court's review is limited to the information given to the architect, to see if he abused his discretion in his decision making.

The issues for review at the court level are complex, and often simply up to the preference of the judge or arbitrator. The best way to ensure that your rights are protected is to know the claim procedures set out in the contract and to pursue them.

e. Consider liquidated damage provisions carefully.

Liquidated damages are damages from a breach of contract whose value are fixed by contract, irrespective of the actual damages caused by the breach. In construction contracts, liquidated damages generally involve specific sums of money forfeited by the contractor because of delayed project completion. Liquidated damages can obviously significantly impact payment for completed work.

Liquidated damages clauses serve at least two purposes. First, they help the owner to ensure that his project is completed on time. Second, they help the owner and the contractor to have some accurate understanding of the costs of delay. Knowing the cost of delay helps people to make decisions during the job and simplifies matters of proof if litigation ensues.

Liquidated damages are a double-edged sword. On the one hand, they hurt the contractor when assessed, and may exceed the actual damages sustained by the owner. On the other hand, they cap the damages. For example, if there is a delay of 30 days, and the liquidated damages are calculated at $100 per day, the owner will be entitled to $3000, whether his actual damages are $2,000 or $20,000.

If the owner attempts to use a liquidated damage provision against the contractor, the contractor should check that the owner has complied with every requirement in the enforcement of the provision. For example, the contractor should ascertain whether the owner has provided timely notice of the delay and whether the owner can actually prove that the fault is being accurately assessed.

If one receives notice that he or she will be assessed liquidated damages for delay, it is important to respond in writing and consistently. Contemporaneous correspondence one of the bests defenses against such claims. Equally important is the consistent use of daily logs. These should describe the causes of delay on an ongoing basis. Such daily reports can go a long way towards insulating a party from liquidated damages.

f. Include clauses giving you the right to stop work.

If you are not being paid because of a dispute, consult an attorney. You may be entitled to pull off the job, which could save your company huge sums of money.

Civil Code section 3260.2 permits an original contractor who has not been paid for 35 days after the due date for a progress payment to

serve a 10-day stop notice work order. The statute gives the contractor the right to costs of demobilization, delay and remobilization.

This is an important right for a contractor. It was enacted in 1999, in an apparent legislative reaction to cases invalidating the pay if paid clause. In other words, when the "pay if paid" clause was invalidated, the contractor lost the right to pass on to the subcontractors the costs of the owner not paying. The "give back" was based on Civil Code section 3260.2 enabling the contractor to walk off the project and to be reimbursed his costs for doing so.

Subcontractors should similar rights in their subcontract agreements.

g. Be aware of performance and payment bonds.

The availability of payment and performance bonds in the general contractor's contract with the owner is a central fact of which subcontractors and material suppliers must be aware. These bonds will ensure that in the event of an insolvent contractor or owner, the subcontractor and material suppliers can be paid.

The subcontractor needs to do this research at the outset, and ensure that 20-day notices are sent to all parties, including the bonding companies, within the proper time frame.

h. Include attorney's fees clauses.

Perhaps the most important clause to enable successful collection is an attorney's fees clause. Almost any attorney's fees clause will do, since they are always reciprocal (they are never one way) and they

generally apply to the whole contract. The only limitation on this rule is attorney's fees clauses related to indemnity claims.

The importance of attorney's fees clauses cannot be overstated. Too often, collection of a claim is too expensive to pursue. Even slam dunk claims must be compromised to avoid the cost of collection. Where there is an attorney's fees clause, the economics of the claim are reversed. A valid claim poses significant risk to the owner of having to pay the claim and fees. Ultimately, the owner can be threatened with a "tail wagging the dog" scenario. An attorney's fees clause can provide significant help in reaching settlement.

American Institute of Architects (AIA) contracts generally do not include attorney's fees clauses. Some Associated General Contractors (AGC) contracts contain this and some do not.

i. Include clauses providing for high interest rates on unpaid bills.

A party would do well to include a clause providing for substantial interest on late payments. When and if a claim goes to court, delay in settlement works heavily against the party who has refused to pay. This encourages settlement and certainly sweetens the pot in the event judgment is rendered.

j. Consider arbitration/mediation clauses carefully.

Parties should be aware of arbitration or mediation clauses in a contract. They may be very helpful to expedite resolution of a case.

An agreement to mediate is basically an agreement to hire a mediator and sit down together and try to work out some kind of

agreement before filing a lawsuit. The mediation process can be dissatisfying because it involves compromises. One method of mediation involves a mediator "hammering on" one or both parties to the mediation. The hammer can be the mediator's evaluation of the relative strength of each party's case. It can also be a "parade of horribles" attendant to any litigation. A mediator attempts to bring the parties to look realistically at the monetary, emotional and time costs of litigation. A mediator can help convince the parties to make distasteful compromises. The rule of thumb is that a settlement was successful and reasonable if both parties come out of it feeling dissatisfied and cheated. Nevertheless, mediation agreements are the result of voluntary decisions. Nobody is forced to agree to a mediated settlement.

Arbitration is very different from mediation. Contractual arbitration is performed before a private arbitrator, usually a retired judge or experienced construction attorney. Arbitrations can follow different procedural rules, which should be spelled out in the arbitration agreement. For example, parties may elect to arbitrate using rules used by the American Arbitration Association (AAA). There are certainly other providers of arbitration services.

In electing arbitration, parties gain some expediency, but give up the right to full blown "discovery" and the right to a jury trial. Discovery is a very mixed blessing. Discovery involves obtaining the other side's documents; having them answer written questions under oath (interrogatories) and being able to take testimony under oath before a court reporter (depositions). This can be expensive, but one gets a very good idea of what the other side has to say about various issues going into trial.

Arbitration limits discovery significantly. Under some circumstances, one may be limited to seeing only the documents the other side proposes to use in the hearing. This is obviously a trade-off. A party saves money, but loses what might be vital information going into a hearing. This trade-off is made at the time one signs a contract with an arbitration clause.

One advantage to arbitration is that you have some say over your choice of an arbitrator. Both parties generally must agree on the arbitrator to be used. The disadvantage is that the arbitrator's decision is nearly unreviewable. Right or wrong, they are final. Court decisions, on the other hand, are appealable. The question is, do you want the expensive Cadillac process (trial) or the less expensive "roll of the dice" approach (arbitration).[6]

Finally, arbitration is not free. An arbitrator's time is expensive. Nevertheless, it can be the quickest and least expensive way of resolving disputes.

There are obviously pros and cons to each approach. Much of the cost of the cases is driven by their actual complexity (some are simple, some are not) and the amounts at issue.

k. Avoid Type I and II indemnity clauses.

An indemnity clause obligates the first party to pay for legal fees and judgments entered against the second party as a result of the actions of the first. Indemnity clauses are commonly intended to address a situation where a subcontractor has done poor work and that work

[6] Even this is an oversimplification. Courts may not be very familiar with construction issues, while arbitrators may be selected for their expertise. A court trial may itself represent a significant roll of the dice.

results in the contractor being sued. The contractor would use the indemnity clause to have the subcontractor pay for his defense.

This is, of course, a very reasonable approach to take. However, facts are not always so black and white, and not all indemnity clauses are created equal. For example, what if the contractor and the subcontractor are equally at fault? Would the subcontractor be responsible for paying all of the contractor's legal fees and all of the judgment against the contractor, event though the subcontractor is not wholly at fault? What if the subcontractor is only 5% at fault? What if the contractor is guilty of "active negligence" and the subcontract simply failed to correct the contractor's error? Will the subcontractor be forced to bear 100% of the liability? The answer is "it depends."

Generally, indemnity clauses are divided into Type I, Type II and Type III indemnity clauses. Type I indemnity clauses make the subcontractor liable for all of the attorneys' fees and the entire judgment entered against the contractor, so long as the subcontractor has a portion of fault. A Type II indemnity clause makes the subcontractor responsible for the contractor's fault so long as the contractor is not "actively" negligent. Type III indemnity clauses involve equitable apportionment of fault.

It is very important to determine the nature of the indemnity clause. A Type I indemnity clause can cause severe problems at the conclusion of or even years after a job is completed. Even if a subcontractor is not at fault, if he has had a Type I indemnity clause invoked against him, he is looking at a great deal of expense and a very difficult time proving that he has no fault in the matter. These Type I, and even Type II, indemnity clauses are to be avoided.

If you do agree to a Type I endorsement, you want to be sure that you are providing the general contractor and/or owner with an additional insured endorsement, otherwise, you will essentially become the insurer of first resort for the contractor whenever your work is implicated in a problem.

V. ENFORCING YOUR CONTRACT RIGHTS

a. Leverage your position using prompt payment statutes.

There are several flavors of prompt payment statutes, governing relations between public and private owners, contactors and general contractors, both in terms of retention payments and in terms of progress payments.[7]

For example, in private contracts, Business and Professions Code section 7108.5 provides that prime contractors must pay subcontractors within 10 days of being paid by the owner. If not, the subcontractor is entitled to a 2% per month penalty and attorneys fee. This is in addition to interest on the contract. On top of this, the contractor may be subject to disciplinary action.

Additionally, owners and contractors must make timely disbursements of retention funds. This is required under Civil Code section 3260.

In public contracts, for example, Public Contract code section 10262 provides for a 2% penalty against any contractor who fails to pay his subcontractors within 10 days of receiving payment from the public entity. The contractor will also be subject to prosecution by the Contractors' State Licensing Board.

Often it is very useful to have counsel point these out in a letter prior to filing suit. These provisions can provide a right to attorney's fees

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[7] Examples of these include Public Contract Code §10261.5, 10853, 20104.50, 10262.5; Business & Professions Code §7108.5, Civil Code §§ 3262.5, 3320, 3321; and Public Contract Code §§7107, 7107.

where none exists in the contract itself. The penalties too can add up to large sums.

b. Further leverage your position with mechanic's liens, stop notices and bond claims.

A contractor or subcontractor who has a pay dispute can always bring an action for breach of contract. However, there are other procedures that can bring more immediate pressure on a deadbeat owner or contractor than a simple lawsuit. These are, of course, suits on mechanic's liens, stop notices and payment bonds.

In order to bring any of these actions, the subcontractor must scrupulously observe his or her obligations to provide 20-day notices to the contractor, owner, the construction lender and the surety under Civil Code section 3097. If the 20-day notice is not timely served, one may still serve a post-completion notice on a surety pursuant to Civil Code section 3242(b) to preserve the bond clause.

Assuming 20-day notices have been properly served, the party who is owed money has several options to pursue.

Filing a mechanic's lien lawsuit can be very helpful. The mechanic's lien can be filed before the completion of the job and suit must be filed shortly thereafter to "perfect" the lien. The filing of the suit will be a headache for both owner and contractor, impairing the owner's ability to obtain additional loans. Once an owner is aware of such a lien, he will likely refuse to pay the contractor until the matter is resolved. The lien is also collateral, so in the unlikely event that the matter is not settled, there is a piece of property from which a judgment could be collected.

A stop notice may be even more effective. Stop notices must be bonded in private works, but need not be bonded in public works. The filing of the stop notice prevents the contractor from being paid the disputed sums. This can get the contractor's attention in a hurry and should expedite settlement of the matter.

Bond clauses are also an excellent way of putting pressure on a party to settle a matter. In the event of a lawsuit, the bonding company can be compelled to pay statutory penalties as well as the underlying judgment. *National Technical Systems v. Superior Court* (2002) 97 Cal.App.4th 415. Bonding companies are not like insurers and will seek to recover their costs and expenses against the contractor. This too is helpful for obtaining settlement.

c. Select the proper forum to file suit.

As noted above, when a party refuses to pay a contractor or subcontractor, a civil suit can be filed. There are several ways this can be done.

If there is an arbitration clause, the suit can be filed in arbitration. The pros and cons of arbitration are discussed above.

If there is no arbitration clause, the suit can be filed in Superior Court. The size of the suit matters a great deal. For claims under $5,000, the best approach is to file in Small Claims Court. Attorneys are not allowed to present claims in Small Claims Court, so it is a much cheaper way to go. Unfortunately, decisions of the Small Claims Court can be appealed to Superior Court and reviewed *de novo*, i.e. as if there were no prior decision. Nevertheless, if one can obtain a judgment from Small Claims Court, this is a simple way to begin collection actions.

If the claim is less than $25,000, the claim can be brought as a limited civil matter, which limits the amount of discovery allowed and provides for additional assistance from the court for early settlement.

If the case is more than $25,000, the case can involve a great deal of discovery and motion practice.

At any point in any case, the parties can, and generally do, settle. It is safe to say that fewer than 5% of cases ever get to trial.

Once a judgment is obtained, then the process of collection on the judgment can begin.

d. Bankruptcy: Why security is not just the job of the military.

One final note. Bankruptcy is the bane of many contractors' existence. The bankruptcy of nearly any party to a construction contact, including an owner, prime contractor, subcontractor or material supplier, can bring the entire job to a halt.

When a party declares bankruptcy, the court imposes a stay, which prevents creditors from seeking to collect from the bankrupt party, and prevents parties from terminating contracts with the bankrupt party without permission of court. The assets of the debtor become the assets of the bankruptcy estate. Thus, when a party goes bankrupt, one of the first things people need to figure out is who owns what? The contract itself can be an asset of the bankruptcy estate. The bankrupt contractor's receivables may or may not belong to the estate. The material delivered to the site may belong to the owner, contractors, subcontractor or the estate. In the case of a bankrupt contractor, there may be some question as to whether the owner can pay the subcontractors and material suppliers be paid for their work directly.

The questions that arise are frankly endless parties confronting these questions should consult competent counsel for answers.

It gets worse. What if you had been having problems with an owner or contractor and after months of dunning letters, finally received the money you were owed, just a few weeks prior to the owner or contractor seeking and obtaining a stay from the bankruptcy court. Do you feel a sense of relief that you managed to get paid before the stay was imposed? Think again. You may be required to disgorge that money to the bankruptcy estate on the grounds that the money represents a preferential transfer.

The best thing you can do to protect yourself from the problems posed by bankruptcies in construction projects is to ensure that obligations to you are secured with some form of collateral, or that you have a direct right of payment independent of the bankrupt debtor. Bankruptcy cases divide creditors into classes. Only when one class is completely paid off will the next class receive payments. Secured creditors are ahead of unsecured creditors. Unsecured creditors have very little hope of being paid much on their claims. Mechanic's liens are good to have in the case of a bankrupt owner because they make the contractor a secured creditor. Mechanic's liens are also a good in the case of a bankrupt contractor, because they can force the owner to pay, when the contractor cannot. Similarly, stop notices can be effectively used to ensure that money that might otherwise go to the bankruptcy estate get used to pay the party which performed the work. Finally, bond claims can provide a means of recovery outside of the bankruptcy estate.

If you have no security, and the time to file mechanic's liens, stop notices and bond claims has expired, the best you can probably do is to

file a claim in the bankruptcy court and then wait for the bankruptcy court to figure out who is owed what, and hope there is money left for unsecured creditors.

VI. CONCLUSION

The recommendations offered here can be boiled down to the following:

Before entering into a construction contract, keep your eyes open and know who you are dealing with. Be careful to maintain your license status and ensure that the people you are dealing with are licensed as well.

When entering into a contract, carefully read the document so that you know what your duties and obligations are under it. You can protect yourself by striking through or rewriting objectionable portions or adding conditions important to you. You may want to seek legal advice when doing this.

Once you begin a project, carefully document your work with daily logs. Document your positions when conflicts arise with timely letters and memos. Observe change order and claim processes outlined in the contract. Most importantly, properly and timely serve 20-day notices on the work.

In the event of a dispute, use the appropriate remedies to put pressure on the parties to the contract. Take advantage of whatever leverage you can, including mechanic's liens, stop notices and bonds claims. Try to make yourself a secured creditor.

Finally, if you do end up in a dispute, seek legal counsel quickly. The time frames for action at the conclusion of a project are very short, in some cases, just a few weeks. Do not delay in getting legal advice.

GLOSSARY

Acceptance – Acceptance of an offer forms a contract. Acceptance occurs when all the material terms of the offer are accepted.

Arbitration – Arbitration is an alternative to court trials. It involves private, for hire, judges whose decisions, in private contracts, are nearly unreviewable by courts.

Attorney's Fees Clause- Attorneys fees clauses entitle prevailing parties to an award of attorneys fees.

Boilerplate Agreements – Boilerplate agreements are pre-printed agreements, containing contract terms that are not negotiated.

Change Orders - Change orders are changes to the construction contract. Normally, there is a formal process for the documentation of a change order, but this process is not always followed. Where these processes have not been followed there can be a question as to whether the party who performed additional work will be compensated under the contract. Change orders can be written, oral or in some cases implied in law or fact as "equitable change orders." The procedures set out in the original contract document can determine the validity of the change order, depending on if those procedures have been enforced or waived.

Express Terms – Express terms are written contract terms.

Implied Consent – Implied terms are "gap filling" terms that are implied by law and read into the contract by a court or an arbitrator.

Integration Clause – Integration clauses set out that the terms found in a contract are the only terms agreed to, and that terms may not be found by examining negotiations or agreements entered into prior to the contract containing the integration clause.

Liquidated Damages – Liquidated damages clauses set the amount of damages due upon certain types of contract breach. In construction contracts, liquidated damage clauses frequently address damages due to delay.

Mechanic's Lien – Mechanic's lien is an encumbrance on real property. The holder of the lien contributed some value to the property, and has a lien in the amount of that added value. The right to a mechanic's lien is guaranteed by the Constitution in California.

Mediation – Mediation is an alternative form of dispute resolution, involving a professional mediator who attempts to help parties reach settlement.

Notice of Completion – A notice of completion is a document recorded at the County Recorder's office indicating that a project is complete. The notice of completion can be the event which begins the

clock ticking for the filing of mechanic's liens, stop notices and payment bonds.

Offer – An offer is the first state of the formation of a contract. The offer sets out the terms proposed by the offeror.

Pay If Paid – A "pay if paid" clause provides that the contractor is only obligated to pay subcontractors if he is first paid by the owner. These are illegal in California.

Pay When Paid – A "pay when paid" clause provides that the timing of a payment from a contractor to a subcontractor is dependent on the date of payment by the owner. However, the pay when paid clause may not act as a condition precedent to payment. The subcontractor has a right to payment. The clause simply allows the payment to be delayed for a reasonable period of time.

Payment Bonds – Payment bonds are bonds that provide that in the event a subcontractor is not paid by the contractor/principal, the surety will pay the amount owing under a contract.

Performance Bonds – Performance bonds are bonds that provide that in the event a contractor fails to complete a project, the surety will step in and pay for the completion of the project on behalf of the contractor.

Progress Payments – Progress payments are interim payments made during the course of a contract.

Prompt Payment Waivers – A prompt payment waiver is a contract term in which a party waives his rights to the protections of the prompt payments statutes. These are illegal under California law.

Retention – Retention is an amount of money, earned by the contractor or subcontractor, but withheld by the party obliged to pay it until the end of the project. The purpose of retention is to ensure performance.

Stop Work Clauses – A stop work clause in a contract provides a subcontractor with the right to cease work in the event of non-payment or some other material breach of contract.

Type I Indemnity – Type I indemnity clauses provide that the indemnitor will provide a defense, and pay the judgment, for an indemnitee, when the indemnitor has any fault in the matter at issue, regardless of the amount of concurrent fault on the part of the indemnitee.

Type II Indemnity – A Type II indemnity clause provides that the indemnitor will provide a complete defense and pay any judgment against the indemnitee where the indemnitor is at least partially at fault and the indemnitee has no active fault in the matter.