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Senate Bill 2577, An Act Promoting Fairness in Private Construction Contracts: Prompt Pay Bill

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On August 10, 2010, Governor Patrick signed into law Senate Bill 2577, An Act Promoting Fairness in Private Construction Contracts aka Prompt Pay Bill. The law, now codified as Chapter 149, Section 29E, fundamentally changes the administration and enforcement of construction contracts in Massachusetts. The statute is expansive and provides several significant changes to current Massachusetts law including among other things the requirement that each applicable contract include specific schedules for the submission, approval, and processing of payment applications and change orders and the statutory right for an unpaid contractor or subcontractor to stop work. The most controversial aspect of the new law, however, is the severe restriction it places on the use of "Pay-if-Paid" clauses.

A pay-if-paid provision is a commonly used contractual device which makes payment obligations to lower-tier contractors contingent upon receipt of funds from third parties. Historically, such provisions have been used by general contractors to ward off (or at a minimum forestall) payment claims from subcontractors clamoring for an otherwise overdue payment. Massachusetts courts generally have upheld such provisions, as long as the applicable contract contained the necessary language. In such cases, although subcontractors still could secure their claims vis-À-vis mechanics liens, their ultimate receipt of payment was often at the mercy of the owner's ability or desire to pay the general contractor. This created the peculiar situation where subcontractors and suppliers essentially bankrolled projects, even though they were most often the parties with the least financial capacity to do so.

All that has changed - or at least it is supposed to - with the enactment of the the Prompt Pay Act. The statute -- which applies to projects where the primary contract exceeds \$3 million and does not include residential projects with 4 dwelling units or less -- expressly prohibits the use of the pay-if-paid provisions. This prohibition, however, is subject to two significant exceptions: first, if the reason for non-payment was due to the default of the party seeking payment; and second, if the third-party payor becomes insolvent, and the party seeking the protection of the pay-if-paid clause lienied the project before submitting its first payment application. The statute requires that these exceptions expressly appear in the contract.

But how will this work in practice? It is highly unlikely that general contractors are going to forfeit altogether the protection of the pay-if-paid provision that has insulated them from subcontractors' claims where the general contractor has yet to receive payment from the owner. It is equally unlikely, however, that general contractors will start to lien every project on which they work at or before the submittal of their first pay application. Although the intent of the drafters of the 1996 revisions to the Massachusetts Lien Act (M.G.L. chapter 254) was, in part, to make the filing of a lien a less confrontational practice, it has not turned out that way. Nearly every construction contract

between an owner and a general contractor contains a provision requiring the general contractor to bond off any subcontractor liens at its own cost and expense. Regardless of the lienor's intentions, a lien is nearly always perceived as an act of aggression.

The general contractor must decide whether the added protection of a pay-if-paid provision is worth the risk of upsetting a business relationship with the owner and potentially losing a customer or project. Some general contractors and subcontractors still longing for the safe-harbor of the pay-if-paid protections are bound to maintain these provisions and file liens to preserve their rights under them. Others will not. The choice boils down to protecting rights versus protecting relationships.

No one knows for certain how the conditional payment restrictions imposed by the Prompt Pay Act will play out once it goes into effect in November 2010. At a minimum, general contractors will no longer be able to rely exclusively on pay-if-paid provisions to provide cover from subcontractors' claims resulting from a non-paying owner. They must perform enhanced due diligence and thorough prequalification of an owner's ability to meet the project's financial obligations. They should engage the owner in a dialogue at the early stages of contract negotiation so that the owner understands the new law and the pay-if-paid restrictions. They should explore alternative security mechanisms so as to ensure payment to subcontractors in the event of insolvency. And they should trust their better instincts to walk away from a potential project if the owner's financing is suspect. The Prompt Pay Act and the limitations on the pay-if-paid defense have made the consequences of taking on a risky job that much more severe.

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