Recession Planning: Protecting Rights to Payment

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The construction industry has been buzzing for the past decade. The population growth and investment of capital into Texas has boosted the state's construction industry to a level of activity that now exceeds pre-Great Recession levels. Generally, and especially in housing, high demand has caused an increase in pricing due to inadequate supply. However, construction spending in Texas has been on the decline for the past five months. The signs of an oncoming recession are becoming clearer and prevalent.

No one can tell us exactly when the next recession will hit, but history tells us that the United States is overdue for a recession. Knowing exactly when to tighten the belt is not as important as knowing you should. Understanding that the volume of dollars available to the industry in advance of that becoming reality will assist astute contractors and business owners in preparing for the next recession. This column, and a short series of columns in upcoming months, will provide information about how to prepare and protect construction companies from nonpayment in advance of a recession.

From a legal perspective, the place to start is the payment section of contracts currently being performed or those subject to bidding or negotiation presently or in the near future. For contracts that are currently underway, unless the project will consume six to 12 more months to complete, the potential for an impending recession may not have an impact. But for those projects that may continue into 2020 or even beyond, the potential impact of recession should be considered.

One way to ensure payment and protection of payment rights is to ensure pay applications are submitted timely and in the form required by contract. If there are administrative obligations or restrictions on the type of information that must be submitted with a pay application, compliance with those restrictions and obligations will ensure timely processing of payment. When cashflow becomes an issue, ensuring one's own actions do not impair or impede payment is essential.

For example, some contracts have terms regarding the inability to process a pay application if unapproved change orders or items have been added to a schedule of values or continuation sheet without all parties' approval. At times, contractors will add change order requests to a pay application in an effort to preserve rights to payment. The unintended consequence of that action may actually result in the payor party withholding payment because of that unapproved inclusion. Contractors who may be trying to protect a right to payment may compromise the actual receipt of payment by not fully understanding how to protect rights and still get paid for undisputed work. If the payor's funding ability becomes compromised over time due to recession related issues, facilitating the delay of payment may result in money evaporating and nonpayment becoming a permanent problem.

Proper use of reservation of rights language and submission of supplemental information with a pay application may better serve a contractor seeking payment. For example, rather than submitting a change order request on the pay application's continuation sheets, issuing a separate claim or letter indicating that work has been done for which payment is required, all while reserving rights to seek payment and a formal claim should suffice in protecting rights to payment without giving the payor an excuse to not pay. Further, contractors frequently become concerned when required to provide a lien release with pay applications for fear that the release will waive rights to payments that may be in dispute. This concern has merit because lien releases and waivers of claims are enforceable even if the signing contractor may not have intentionally waived a claim or realized it was waiving a claim by signing the form. Contractors can write a note on the required waiver form with a call-out or an asterisk calling out a reservation on the form itself.

If needing to preserve rights to payment while being required to provide claim wavers and lien releases, including an asterisk with a note indicating that the waiver does not apply to a certain amount of money or a particular item in dispute will preserve one's rights. Simply writing "excluding change order request for (description) scope of work" will allow the waiver to be submitted and payment rights to be preserved.

Following the above advice item for current and future contracts is important. Also important for future contracts, because tightening cashflow may become an issue if a recession arrives, is having payment terms that require payment of undisputed items rather than allowing an entire pay application to be rejected due to the inclusion of disputed work items. If the payor has an absolute obligation to pay, then there will be less concern that a payment will be significantly delayed due to prolonged negotiations about an item in dispute.

Further, including language that will allow suspension of work for events of nonpayment is another tool to avoid impact from nonpayment. In many contracts, such language if allowed and agreed by both parties, has a fairly long lead until the remedy becomes available. For suppliers and derivative or lower tier subcontractors, that lengthy lead may have a highly negative impact on cashflow and the ability to continue to perform. Having the ability to cease performance if payments are 30 days or more late gives some leverage to the performing entity to both secure payment in a timely manner and to protect one's own cash while payments trickle down.

Being proactive in submitting claims, reserving rights, and using contractual tools to prevent falling behind on payments are all things contractors should be doing to prevent negative and potentially catastrophic impacts from nonpayment. Recognizing that contract negotiations can be challenging, using the tools available under any contracting scenario to free up cashflow and ensure some, if not all, money that is owed makes its way to the performing contractor will help weather an impending storm.

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