

CONSTRUCTION AND THE LAW IN TEXAS

Point/Counter-Point: Payment and Offset Claims

With this column, I am going to embark on a new series of articles that seek to address situations involving claims that arise on construction projects. The goal of this series is to provide some education and food for thought for those of you charged with dealing with these claims for your companies. Hopefully, this point/counter-point will provide some helpful information in resolving similar situations that might be encountered on projects.

If you have been in the construction industry long enough, especially if you have found yourself involved in a legal claim or dispute, you've come across a situation where a supplier or subcontractor has asserted claims for nonpayment under a purchase order or subcontract and the general or prime contractor asserts an offset or back-charge as a defense to payment.

This situation is not limited to general contractors. With our highly tiered industry, subcontractors routinely sub-subcontract portions of their scope and virtually everyone, except those who solely provide labor, have the potential risk of supplier interference with schedule and performance. Even self-performing contractors in the heavy construction industry often subcontract with specialty contractors for project features such as bridges or tunnels.

Scenario:

A subcontractor has fully performed its scope of work on a project. But, during the course of performance, it impacted the work of others because of its failure to meet certain performance milestones. This failure resulted in lost days and schedule creep. Near the completion of the project, the subcontractor submits a final pay application seeking full payment for its contract balance. The prime contractor

responds with a rejection notice informing the subcontractor that its failure to perform timely harmed the project and damaged the prime contractor.

Additionally, the contractor informs the subcontractor that the schedule has been extended, the owner has not granted any time extensions, and any liquidated damages or other delay damages assessed by the owner will be passed on to the subcontractor and offset from any contract balance owed to the subcontractor.

In order to offset the actual damages and cover potential exposure for other damages, the contractor withholds all of the subcontractor's contract balance. Let's assume for this example that the subcontract agreement allows the contractor to withhold sums owed to it for damages caused by the subcontractor but requires the contractor to pay any remaining funds to the subcontractor. The subcontract does not address timeliness of the final payment when offsets are asserted. The subcontract does have a broad indemnity clause whereby the subcontractor must indemnify the contractor for all costs of any kind associated with damages caused by the subcontractor, including attorney's fees, home office overhead, and other expenses.

In this scenario, let's assume the subcontractor's last draw, including retainage, was for \$250,000. The contractor claimed \$150,000 in damages as an offset due to impacts resulting from the missed milestone. The contractor also anticipated up to \$50,000 in LDs and up to \$150,000 in legal fees to deal with the lawsuit threatened by the subcontractor. Because of the estimated \$200,000 actual loss and the anticipation that legal fees could, along with the actual and anticipated damages, far exceed the contract balance, the contractor withheld all amounts owed.

Based on the above, the contractor will likely feel justified in its actions. Certainly, for a reasonable amount of time after the dispute has boiled over, the contractor can withhold the funds to determine the final exposure it has to damages caused by the subcontractor. But the dollars withheld by the contractor do not exceed the contract balance if the owner does not withhold LDs and the attorney is not required.

Speculative damages are not recoverable so, to avoid facing the possibility of becoming involved in a lawsuit where the subcontractor will win even if the contractor proves all of its offsets, the contractor should remit the unused portion of money even if there is not 100 percent certainty that the anticipated damages will not accrue.

The risk in this scenario is that the subcontractor will file suit and the contractor will not actually get penalized for LDs. There is also a risk that a judge, jury or arbitrator will not factor attorneys fees into the underlying claim until it determines the rightful amount owed after all allowable project costs equaling the offset. Depending on what each party can prove and the math ultimately involved, it's easy to envision an outcome where the contractor prevails fully on its offset claim but loses the case and owes the contract balance and all of the subcontractor's attorney fees.

The counter-point is that the subcontractor clearly missed a key milestone and should be responsible for the impacts. If the contractor pays the contract balance and the subcontractor still sues, the contractor will be in a much stronger position to getting fully reimbursed for all costs. The subcontractor would not be able to recover any contract balance and, because the contractor would have incurred some attorney's fees defending the suit, it



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A Balanced Approach to Construction Law.

can generally expect to be awarded its attorney's fees under the contractual indemnity clause.

The take-away is simple. On both sides of this dispute, one should carefully evaluate the impacts on the project and the value of those impacts, if any. Also, one should concentrate on getting an accurate accounting and understanding of how the math works in the ultimate resolution and strategy of the dispute. If the final evaluation shows that, as a dispute then stands, the potential and likely result does not favor your position, take the necessary actions to either resolve the dispute or turn it in a way that you become the favored party.

Finally, consider this – the entire situation changes if the subcontractor's milestone was not on the critical path of the project or there were concurrent or subsequent delays that impacted the project to a similar or greater degree that this subcontractor's missing its milestone. That scenario and evaluating delay claims will be discussed in a future column. 🐾

