Payment Terms: Adequate Assurances of Payment

Introduction: Legal Right to Demand “Assurances”

As a general rule, the largely judge-made law governing contract interpretation permits one party to a contract to suspend its contractual performance when there are “reasonable grounds” to believe that the other party will not perform its end of the bargain. Similarly, Uniform Commercial Code (UCC) provisions that apply to sales of goods empower suppliers to suspend performance “if commercially reasonable,” when there are “reasonable grounds for insecurity” and a written “demand [for] adequate assurance of due performance” has been delivered to the buyer.¹

It should be noted that the right to suspend performance is a remedy that must be exercised with extreme caution and not without close consideration of all the facts and consultation with knowledgeable construction counsel. Subcontractors often have reasonable grounds to believe that payments will not be forthcoming and probably more often could discover reasonable grounds to believe payments will not be forthcoming upon a diligent investigation. Unfortunately, subcontractors are often not aware of their power to actually stop working until they receive credible assurances of payment.

As a result, subcontractors under-utilize their right to project financing information that might otherwise put them on their guard and trigger their right suspend contractual performance. The Restatement (Second) of Contracts, a compendium of the common law of contracts published by the American Law Institute explains that:

Where reasonable grounds arise to believe that the [debtor] will commit a breach … the [creditor] may demand adequate assurance of due performance and may, if reasonable, suspend any performance for which he has not already received the agreed exchange until he receives such assurance.²

Subcontractors who aggressively inquire about financing arrangements for a construction project can, at the beginning of the project and even as the project progresses, improve their chances of discovering reasonable grounds to believe that payment may not be forthcoming. If this happens, they then preserve their right to suspend work for cause and thereby improve the chances of actually getting paid.

¹ UCC § 2-609.
² § 251(1) (emphasis added).
Subcontractors should especially consider making (or renewing) demands for project financing information when extra work is requested. Lack of owner approval for extra work, or lack of owner agreement on the value of extra work, should ordinarily cause a subcontractor at least some insecurity about payment. That insecurity is magnified as the cost of requested extra work increases, particularly where other extra work, already properly performed, remains unpaid.

On the other hand, a contingent payment clause, which makes the contractor’s payment obligation to the subcontractor contingent upon actual receipt by the contractor of payment from the owner, arguably undermines the subcontractor’s right to demand adequate assurances of payment and concurrently suspend work. Consider the portion of the Restatement quoted above, where it states that the subcontractor must have “reasonable grounds to believe” that the contractor “will commit a breach.” Can nonpayment be a breach of a “pay-if-paid” subcontract if the contractor is never paid by the owner?

There’s no question that a missed payment can justify a suspension of work, or even outright termination of the subcontract, where the contractor’s payment obligation is not contingent on its receipt of payment by the owner, as under a typical “pay-when-paid” clause. According to one federal trial judge, “authorities uniformly state that a subcontractor who is unreasonably denied payment as he progresses towards completion is justified in suspending performance until he is paid.” Moreover, subcontractors are “justified in suspending” because “one reason for providing for installment payments as construction proceeds is to supply the funds necessary for the agreed performance.”

That sort of reasoning supports an argument that even subcontractors who do agree to pay-if-paid contract language must still have some right to demand

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3 I.e., contingent payment.

4 Subcontract payment clauses ordinarily do require the contractor to make payment a certain number of days after the contractor is paid, but not all such clauses will be treated by the majority of courts as contingent payment clauses. See e.g., Koch v. Construction Technology, 924 S.W.2d 68 (Tenn. 1996) (ASA appeared as amicus curiae), treating a pay-when-paid clause (“Partial payments subject to all applicable provisions of the Contract shall be made when and as payments are received by the Contractor”) as establishing a reasonable time for payment only, and not as shifting the risk of owner nonpayment to the subcontractor. In the vast majority of states payment must be made within a “reasonable” time unless the language clearly and unambiguously shifts the risk of owner nonpayment to the subcontractor. Court decisions in Alaska, Georgia, Idaho, Illinois, and Michigan, arguably place those states in a minority that is more willing to interpret payment clauses as “pay-if-paid” clauses. See Katz, Gerald I., “Analyzing and Avoiding Contract Risks,” International Risk Management Institute, 2004 (presented at the 24th Annual IRMI Construction Risk Conference), pages 41-61 (http://www.irmi.com/Conferences/Crc/Handouts/Crc24/Workshops/AnalyzingAndAvoidingContractRisks.pdf (May 25, 2005)).


6 Id.
adequate assurances and concurrently suspend performance, because the purpose of progress payments is to enable continued performance. Clearly, however, a subcontractor could not pursue such a course without tremendous risk.

As a result, pay-if-paid terms put a premium on accurate, up-front evaluations of the adequacy of project financing arrangements, before the subcontractor starts work or signs the contract. Regardless of the payment terms, however, reviewing verifiable project financing arrangements, such as a construction loan agreement or evidence of deposits sufficient to cover the likely costs of construction, has real potential to improve a subcontractor’s odds of payment.

**Subcontractor Entitlement to Project Financing Information**

The notion that project financing arrangements are “none of your business” is a fallacy. Subcontractors are creditors who provide labor and/or materials on credit, for a promise of payment in the future.

Creditors who lend money are never too shy to ask for detailed information evidencing an ability to pay. Subcontractors should be no different. Furthermore, typical subcontract terms set due dates for payments based on the dates that the prime contractor actually receives payment from the project owner, and not according to any pre-determined schedule. By their very terms, then, pay-if-paid and pay-when-paid clauses make the owner’s financing arrangements a subcontractor’s business.

“Pay-if-paid” subcontract terms, which make payment by the owner a condition precedent to the prime contractor’s obligation to pay its subcontractor, often even explicitly state that the subcontractor “relies upon the credit of the Owner, not the Contractor for payment....”7 “Pay-when-paid” subcontract terms don’t shift the entire risk of owner nonpayment to the subcontractor, but they still shift the risk of late payment to the subcontractor – that’s the whole point!

The introduction to the “Guidelines for Obtaining Owner Financial Information,”8 published by the Associated General Contractors of America (“AGC”), aptly notes that in "any contractual venture, each party has a legitimate interest and responsibility in ascertaining whether the other party is fully capable of performing all of its contractual obligations” and

The proven ability to pay is just as important as the proven ability to perform. A contractor, therefore, has an equally

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7 AGC Document No. 655 (1998) at ¶ 8.2.5
valid interest in receiving assurances that a project owner has sufficient funds available to make payments in accordance with the terms of the construction contract.

The Guidelines for a Successful Construction Project, jointly adopted and promoted by AGC, ASA, and the Associated Specialty Contractors (“ASC”), provide that “[i]t is your responsibility, if a subcontractor, to research the owner’s ability to pay for the project and the general contractor’s ability to pay those with whom it has contracts for goods or services.” The Guidelines also point out:

The person most responsible for prompt and complete payment is you. Protect yourself and your company. Understand and research the payment requirements of each individual project and the owner’s ability to pay. It is not only your right but also a prerequisite for your success in the construction industry.

Types of Project Financing Information Subcontractors Should Seek

ASA publishes a questionnaire for subcontractors to use in collecting information from general contractors about their credit-worthiness and the solvency of the contemplated project. With regard to the owner, the questionnaire requests information that could be used to enforce mechanics’ liens and payment bond claims. It also requests information about the identity of the owner’s lender and the type, amount, and terms of the loan.

The American Institute of Architects (“AIA”) provides additional guidance for general contractors in its Commentary to the A201-1997:

Reasonable evidence of the owner’s ability to finance the project may be a loan commitment letter from an institutional lender, a governmental appropriation or other equally convincing documentation. If financial arrangements will not be concluded prior to execution of the agreement, a

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9 ASC is an umbrella organization including the Mason Contractors Association of America, Mechanical Contractors Association of America, National Association of Plumbing-Heating-Cooling Contractors, National Electrical Contractors Association, National Insulation and Abatement Contractors Association, National Roofing Contractors Association, Painting and Decorating Contractors of America, and the Sheet Metal and Air Conditioning Contractors’ National Association.

10 Guideline on Contractors Payment Rights, Obligations and Responsibilities (http://www.constructionguidelines.org (May 25, 2005)).

11 Id. (emphasis added).

12 Available to ASA members at http://www.asaonline.com in the members-only section.
ConsensusDOCS resources, on the other hand, suggest that contractors should look beyond loan commitments. The ConsensusDOCS are endorsed by the ASA, and those documents “Guidelines for Obtaining Owner Financial Information” explain that the actual loan agreements for construction and permanent financing are preferable over a simple commitment letter, "because the loan documents will include all of the lender conditions and requirements. Of significance are the requirements for notification to the lender, whether the lender must approve changes, and assignment of the contract to the lender." The “Guidelines” also provide tips for evaluating loan commitments and other documents, such as:

10. Beware of a loan commitment that covers items other than construction.
11. Request a lender’s “set-aside” letter that acknowledges the portion of construction loan proceeds available exclusively for payment of construction draws.
   *   *   *
18. Ask for a copy of the owner’s agreement with the architect. This will assist in assessing whether sufficient funds are available to cover the owner’s financial obligations, particularly if loan proceeds can be used to pay design costs. It will also identify the architect’s contract administration responsibilities and whether the architect’s responsibilities are consistent with the provisions of the general conditions (ConsensusDOCS 200 or A201) for the project.

ConsensusDOCS “Guidelines” also suggest obtaining the owner's credit report, and are distributed with an “Owner Financial Questionnaire” providing a checklist of items including the owner’s Dun & Bradstreet rating, bank references, and certified financial statements.

Industry Practices Favor Disclosure of Financial Information

Provisions assuring that a general contractor will have the right to disclosure of project financing arrangements are increasingly common in industry standard documents and legislative enactments. Subcontractor rights have been less well defined, although the use of either pay-when-paid or pay-if-paid terms in

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construction subcontracts has become ubiquitous in both public and private construction.

Prompt pay laws governing payment of subcontractors, which regulate public procurement, private construction, or both, generally require payment of subcontractors within a certain number of days after the contractor is paid, and so any payment delays from the top translate into payment delays to all of the contractor’s subcontractors.\(^\text{16}\) Thus, the state and federal prompt pay laws essentially institutionalize pay-when-paid payment terms.\(^\text{17}\)

1. Public Procurement

Federal law has long provided that no federal agency can enter a construction contract “for any public improvement which shall bind the Government to pay a larger sum of money than the amount in the Treasury appropriated for the specific purpose.”\(^\text{18}\) Thus, the federal government requires construction projects to be fully funded from commencement. In fact, it is an implied term of every federal government contract that the contract amount is subject to the amount appropriated.\(^\text{19}\)

The federal policy is mirrored in states and localities throughout the country. It is the “prevailing rule” of public contracts that construction contracts are void if the governmental entity entering into the contract fails to comply with a constitutional or statutory provision requiring it to, before incurring indebtedness, appropriate the necessary money for the contract.\(^\text{20}\)

In the public procurement context, then, contractors are provided with adequate assurances of project financing in the form of public appropriations laws, statutes and ordinances, which are openly disclosed to any members of the public curious enough to look.

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\(^{16}\) Provisions requiring payment of interest on late payments ameliorate the problem, at least where such interest can be collected economically.

\(^{17}\) See, e.g., 31 U.S.C. § 3901 et seq. (the federal Prompt Payment Act) and implementing regulations at 48 CFR § 52.232-27.

\(^{18}\) 42 U.S.C. § 12. The Administrator of General Services, can, however, enter contracts that exceed appropriations, but only up to an amount fixed by Congress as the “full limit of cost” in a partial appropriation. 41 U.S.C.A. § 261 (2001). The absence of case annotations in West’s annotated version of the Code suggests that Congress has made its appropriations over time match the “full limit of cost” designated in an earlier year, at least since the law was passed in 1908. In Curtis v. United States, 2 Ct. Cl. 144, 151-152 (1866), however, it was held that a statute which fixed the amount to be expended for construction of a mint at $300,000, prevented additional payments to the contractor, as it “gave to the contractor the plainest and the clearest notice that all its expenditures and liabilities should not exceed a fixed and certain sum.”


2. Model Contract Forms

Popular construction contract forms published by all segments of the construction industry, including AIA,21 ConsensusDOCS, the Construction Management Association of America (“CMAA”), and the Design Build Institute of America (“DBIA”), not only recognize the importance of adequate information to assess the financial viability of a construction project,22 but actually allow the contractor to stop work if the owner fails to provide that information on request.

A. **ConsensusDOCS and AIA on Project Financing.**

The ConsensusDOCS and AIA A201 forms explicitly obligate the owner to give notice of any changes in project financing.

The ConsensusDOCS 200 (2007), at ¶ 4.2, is endorsed by the ASA and affords “condition precedent” protection for the contractor’s right to seek project financing disclosures. It provides that before commencing Work:

> and thereafter at the written request of the Contractor, the Owner shall provide the Contractor with evidence of Project financing. Evidence of such financing shall be a condition precedent to the Contractor’s commencing or continuing the Work. The Contractor shall be notified prior to any material change in Project Financing.23

ASA’s Addendum to Subcontract (2008),24 in turn, seeks to promote the trend favoring financial disclosures down the contractual chain. Like the protection afforded to general contractors in the AIA and ConsensusDOCS forms,25 the Addendum sets up the contractor’s obligation to provide disclosures to the subcontractor as a condition precedent to the subcontractor’s performance:

4. **Financial Information.** The subcontract is subject to credit approval by Subcontractor, and Subcontractor shall be provided with the legal description of the property, the name, address and representative of the project owner, evidence of adequate owner project financing, and a copy of Customer’s payment bond for the project, if any. Customer shall

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21 Available for purchase at [http://www.contractorsknowledgenetwork.org](http://www.contractorsknowledgenetwork.org)
22 See: AIA A201-2007 at ¶ 2.2.1; ConsensusDOCS 200 (2007) at ¶ 4.2; CMAA A-1 (2002) at ¶ 7.13; DBIA 535 at ¶ 3.3.1.
23 ConsensusDOCS 200, ¶ 4.2 FINANCIAL INFORMATION.
24 Available to ASA members at [http://www.asaonline.com](http://www.asaonline.com) in the members-only section.
25 A completely unmodified A401 arguably also protects subcontractors, because it incorporates the unmodified A201 by reference (¶ 1.2) and contains a mutual, flow-down/flow-up provision (¶ 2.1).
promptly notify Subcontractor of material changes in the project owner’s identity or financial arrangements. Subcontractor shall not be obligated to commence or continue Subcontract Work absent adequate assurances of payment.

Like the ConsensusDOCS 200, The A201-2007, provides that before commencing the Work, the contractor may request in writing that the Owner provide "reasonable evidence" that it has made financial arrangements to fulfill its obligations under the Contract. However, the A201 is not as broad as the ConsensusDOCS in that while it does not allow the contractor to make such request after work begins unless a series of conditions are met.

Once the request is made, however, the Owner is required to "furnish such evidence as a condition precedent to commencement or continuation of the Work or the portion of the Work affected by a material change." Like the ConsensusDOCS 200, the A201 (2007) provides that after the Owner furnishes the evidence, it may not materially vary such financial arrangements without first notifying the Contractor.

By making financial disclosure a "condition precedent" to either commencing or continuing work, the ConsensusDOCS 200 and AIA’s A201-2007 make project financing disclosures perhaps the most easily enforced of any rights provided to the contractor in the general conditions.

AIA’s A401-2007 subcontract document, on the other hand, does not mention project financing disclosures, although it does incorporate and flow-down the provisions of the A201-2007. The AIA’s more recent publication, the A142-2004 Standard Form of Agreement Between Design-Build and Contractor, however, provides that "[t]he Design-Build shall, at the request of the Contractor, prior to the execution of the Agreement and promptly upon request thereafter, furnish to the Contractor reasonable evidence that financial arrangements have been made to fulfill the Design-Build’s obligations under the Agreement."

B. The Other Trade Forms on Rights to Project Financing Information.

The General Conditions of the Construction Contract Between Owner and Contractor published by the Construction Management Association of America ("CMAA") does not provide contractors with an explicit right to financial information.

References:

26 A201 (2007 ed), ¶ 2.2.1.
27 ¶ A.2.2.6
Interestingly, however CMAA’s agency document, the Standard Form of Agreement Between Owner and Construction Manager, does provide disclosure rights to the construction manager (“CM”), who is responsible, among other things, for a “bidder’s interest campaign.” The campaign for bidders is aided by ¶ 7.13 of the document. Under that subparagraph the owner is required to furnish evidence satisfactory to the CM that sufficient funds are available and committed for the entire cost of the Project. And

[u]nless such reasonable evidence is furnished, the CM is not required to commence the CM’s services and may, if such evidence is not presented within a reasonable time, suspend the services specified in this Agreement upon fifteen (15) days written notice to the Owner. In such event, the CM shall be compensated in the manner provided in Paragraph 10.2.

“Paragraph 10.2” requires, among other things, that the CM be compensated for the cost of site staff, and “assigned Project home office staff,” during a suspension. Note, however, that the portion quoted from the CMAA agency form: (1) requires the CM to provide 15 days written notice before suspending, and (2) does not make financial disclosure a condition precedent to the duty to perform as under the ConsensusDOCS 200 or A201-2007.

The Standard Form of General Conditions of Contract Between Owner and Design-Builders, published by the Design-Build Institute of America (“DBIA”), also seeks to ensure that design-builders will have access to project financing arrangements by providing them with the right to stop work after providing a seven day notice:

At Design-Builder’s request, Owner shall promptly furnish reasonable evidence … that Owner has adequate funds available and committed to fulfill all of Owner’s contractual obligations under the Contract Documents. If Owner fails to furnish such financial information in a timely manner, Design-Builder may stop Work under Section 11.3 hereof or exercise any other right permitted under the Contract Documents.

3. Government Regulation

30 DBIA Document No. 535 (1998) at ¶ 3.3.1 (The referenced “Section 11.3” requires the design-builder to give 7 days notice to cure before stopping work.)
Since October 2001, California law has required many private owners to provide contractors with security for the owner’s payment obligations. The law requires owners for covered projects to secure their payment obligations to contractors with either: (1) a payment bond or irrevocable letter of credit for at least 15 percent of the contract amount; or (2) a “construction security escrow account” in which the contractor has a first priority security interest. Where the escrow account is used, the owner must deposit at least 15 percent of the contract price into the account prior to commencement, and must also deposit all retainage in the account as the project proceeds.

Conclusion

Subcontractors are well-advised to add conditions to their bid proposals that make acceptance “subject to approval of the owner's credit by the subcontractor, which shall not be unreasonably withheld.”

The project owner’s financing arrangements are the business of every contractor and subcontractor. Subcontractors who aggressively pursue disclosures of construction project financing arrangements will greatly improve their chances of avoiding financially troubled projects.

Even after starting work, subcontractors who review project financing information may improve their chances to discover a reasonable basis for believing that payment may not be forthcoming, enabling them to suspend work before becoming over-extended. This will improve their chances of actually getting paid. Subcontractors should remember to renew demands for project financing information when extra work is requested, in order to satisfy themselves that amounts beyond the original contract amount will actually be available for payment.

31AB 1534, 2001-2002 legislative session, adding new California Civil Code § 3110.5.