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Managing the Risk of Non-Payment:
Recourse for Residential Contractors

Contractors specializing in residential construction are well aware of the risk that an owner may not make timely payments during construction. Delayed payment or a complete lack of payment can weigh heavily on residential contractors who must pay their employees, subcontractors, and/or suppliers. Despite assurances from the owner that payment is forthcoming or the appearance of owner solvency, there is no guarantee that work performed will be paid for in a timely manner. In fact, the recent economic downturn has highlighted the harsh reality that an owner may become insolvent with little or no warning. During these challenging economic times and in the face of clear risk, contractors should be aware of business and legal strategies that can be used to protect their interests. This article addresses strategies that contractors may find useful for increasing the likelihood of prompt payment and obtaining security in the event of non-payment.

NEGOTIATING THE CONSTRUCTION CONTRACT TO REDUCE RISK

Negotiating a construction contract that addresses the parties' rights and duties for any given project is a critical step in managing risk. Contractors may rely on standard form contracts published by the American Institute of Architects ("AIA") or ConsensusDOCS, internal form contracts, or draft contracts from scratch. Regardless of the source or form, careful attention should be devoted to negotiating the construction contract, as it will be carefully scrutinized in the event of a dispute.

Certain contract provisions may reduce a contractor's exposure to untimely payments. For example, the contract should include a description of the project payment type, such as lump sum, unit price, cost plus, or cost plus with a guaranteed maximum price ("GMP"). The contract should clearly identify the procedures and timelines for periodic and final payment, including the billing cycle, the owner's allotted review period, and the deadline by which payment is due. The contract should also describe the change order process that the parties will follow if changes become necessary. Addressing the parties' duties and responsibilities in the contract is an important step in avoiding confusion and debate during the project.

The contract should also address the parties' rights in the event of non-payment. Contractors may seek to include a stop-work provision, allowing the contractor to temporarily or permanently halt operations in the event of non-payment without the risk of being declared in default. Contractors should also be aware of clauses impacting their ability to obtain security in the event of non-payment, such as lien waiver clauses.

IDENTIFYING NON-PAYMENT RISK INDICATORS DURING CONSTRUCTION

Once the contract is signed, the next step in guarding against the risk of non-payment is being able to identify the possibility of non-payment. A leading indicator of the potential for non-payment is an abrupt change in the owner's previous payment methods, including delayed payment or partial payment of invoices. This may be the first warning sign of an owner's financial woes. Other non-payment risk indicators include an owner's default under the contract, lack of communication, and adverse industry or market conditions. Contractors who are aware of the "big picture" may be able to identify the risk of non-payment early, before a substantial amount of work is performed without payment.

HOW TO DEAL WITH THE POTENTIAL FOR NON-PAYMENT

If the potential for non-payment is identified while construction is ongoing, a contractor has a number of options. First, a contractor should continue to maintain control of project relationships and focus on recoverability. Opening the lines of communication with the owner and/or lender may uncover the source of the problem and may allow the parties to negotiate payment terms and/or schedule changes. Discussions or negotiations may provide the owner with options to get through the financial issues that may be present.

If the risk for non-payment is identified near the completion of construction or after substantial completion, the contractor may elect to immediately take steps to secure the debt. Statutory limits on the time periods for perfecting a mechanic's lien or filing a lawsuit may play an important role in any such decision.

NEW HAMPSHIRE MECHANIC'S LIEN STATUTE

A mechanic's lien allows contractors (and subcontractors, suppliers, and laborers) to obtain security for unpaid construction debts by providing for a lien against the property on which construction is being performed. The New Hampshire mechanic's lien law is set forth by statute in RSA Chapter 447. In general, any person who, by himself or with others, performs labor or furnishes materials in the amount of $15 or more is entitled to a mechanic's lien. For a party to qualify for a mechanic's lien, it must have a direct contractual relationship with 1) the owner; 2) the general contractor; or 3) a first-tier subcontractor of the general contractor.

A contractor creates a mechanic's lien as a matter of right as soon as it performs work. The lien, however, has no legal effect, and thus cannot be enforced, until it is perfected by providing written notice to the owner and later secured (or enforced) by filing a lawsuit. New Hampshire courts strictly observe the statutory process and time limits for perfecting and securing a mechanic's lien, which must be secured within 120 days after the party seeking the lien last performed labor or supplied materials to the project. The lien is perfected by filing a lawsuit through a Writ of Summons and a Petition for Ex-Parte Attachment on a Mechanic's Lien.

In general, the amount of a mechanic's lien is the amount of labor or materials provided to the project. Practically speaking, the value of a lien is limited to the amount of the owner's equity in the property as of the date the lien attaches. In other words, like any other junior security interest, a mechanic's lien claim is always subject to potential foreclosure by the rights of a senior mortgagee or other secured interest in the property. Once a mechanic's lien is perfected, the lien can then be used to foreclose on real property to recover the sums due the contractor, similar to how the foreclosure of a mortgage results in the sale of property for failure to make mortgage payments. Generally, however, the filing of a mechanic's lien does not lead to the actual sale of property, but instead provides security and leverage for collecting monies owed. Contractors, subcontractors, and materials suppliers should be aware that the courts require strict compliance with the statute, and any deviation in the requirements may be fatal to perfecting the lien.

If a mechanic's lien is not available, an unpaid contractor may wish to seek a pre-judgment attachment on real or personal property pursuant to RSA 511-A, or trustee process pursuant to RSA 512. A contractor may seek an attachment of the owner's real estate, property, goods, or rights or credits, to secure any judgment that might be obtained, by filing a lawsuit and a petition to attach pursuant to RSA 511-A. The owner may object to the making of an attachment and is entitled to a hearing. At the hearing, the contractor must show that there is a reasonable likelihood that it will succeed on the merits of its claim. If the contractor meets this burden, it is entitled to an attachment unless the owner establishes to the satisfaction of the court that his assets will be sufficient to satisfy a judgment against him in the amount sought with interests and costs. RSA 511-A:8 allows the court to grant a motion to attach without notice to other party under certain exceptional circumstances, for example, where there is a substantial danger that the property may be damaged, destroyed, concealed, or removed from the state. Finally, a contractor may seek to attach an owner's bank accounts by filing a lawsuit and motion for trustee process pursuant to RSA 512. These options provide the contractor with some limited means to secure an unpaid debt in the absence of a mechanic's lien.

CONCLUSIONS

Contractors should be mindful of the risk of owner non-payment and take affirmative steps to protect their interests before construction begins. A well-drafted contract with clear payment requirements may assist a contractor in obtaining timely payment and may avoid uncertainty and confusion during construction. If it appears that the owner will default or otherwise become unable or unwilling to pay, contractors should be aware of available methods by which to secure payment for unpaid debts, including statutory mechanic's liens and/or pre-judgment attachments.

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