

Collections for Contractors

A Guide to Collecting Construction Monies

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INTRODUCTION

Construction receivables are worthless if they cannot be collected. This guide covers the most common methods of collecting construction monies in Arizona. It provides an overview of key elements of each collection method, and considerations for selecting which are the most appropriate for a given construction project.

Arizona law provides a variety of avenues for collecting construction receivables, ranging from contractual terms to statutory provisions on liens, stop notices, and payment practices. Each of these avenues has its own advantages and requirements. But, with understanding and diligence, contractors can put their companies and themselves into position to collect more construction monies, more often.

PROMPT PAY ACT

Arizona's Prompt Pay Act, A.R.S. §§ 32-1129, *et seq.*, sets deadline by which construction receivables must be paid. Under Arizona law, a project owner has fourteen days to review and certify a written invoice or payment application by a general contractor. If the owner does not agree with the invoice or application, it must specify in writing to the contractor what specific items are in dispute. If the owner does not provide a written objection within fourteen days, the invoice or application is deemed certified as a matter of law, and must be paid within seven days thereafter.

Thus, a project owner has fourteen days to object to a billing, or a maximum

of twenty-one days to provide payment. While a construction contract may provide for different payment terms, these terms must appear prominently on both the plans and in the contract.

In turn, a contractor must pay its subcontractors and suppliers within seven days of receiving funds from the owner for the subcontractor's or supplier's scope or materials.

There are important conditions to this obligation, however. A general, subcontractor, or supplier must have submitted a written invoice for the labor or materials. Lien releases must also be submitted.

If these conditions are satisfied, however, an owner or contractor's failure to make timely payment of certified funds is grounds for suspension of work, or termination of performance without liability for breach of the construction contract. However, a contractor or subcontractor must provide at least seven days written notice of its intent to suspend or terminate.

The Prompt Pay Act also provides subcontractors and suppliers with a way to determine when an owner has made payment for their scope of work. Under A.R.S. § 32-1129.01(L), a subcontractor or supplier may send a written request to the owner, which then must notify the sub or supplier within five days of its issuance of a progress or final payment to the contractor.

As discussed below, a claim under the Prompt Pay Act may be to the Registrar of Contractors (ROC) or in civil court.

CONTRACTUAL TERMS

A “Pay if Paid/Pay When Paid” clause (also known as a “paid when/if clause) is an important if not essential payment term for general contractors to include in their subcontracts. Conversely, subcontractors should seek to avoid paid when/if clauses in their dealings with general contractors or upper tier subcontractors.

Why? Because a paid when/if clause is in essence a transfer of risks and obligations for payment. By agreeing to a paid when/if clause, the parties to the contract agree that the sub or supplier is not entitled to payment from the upper tier contractor or sub **unless and until** the contractor or sub receives payment from the owner for that scope of work. The risk of payment delays or defaults is transferred from the contractor to the subcontractor or supplier.

Not all paid when/if clauses are enforceable, however. A valid paid when/if clause must meet the requirements set forth by the Arizona Court of Appeals in *L. Harvey Concrete v. Agro Construction Supply Co.*, 189 Ariz. 178 (1997). An example of an invalid paid when/if clause would be:

“Subcontractor agrees that contractor has no obligation to pay Subcontractor for any work performed by Subcontractor until and only if Contractor receives payment from Owner.”

On the other hand, a valid paid when/if clause is set forth below:

“Subcontractor agrees as a condition precedent to payment, of either progress or final payment, that the Owner shall have first paid the payment applied for to the Contractor, and that payment for either progress payments or final payment is not due and owing to the Subcontractor as provided for herein until the Owner has made such payment to the Contractor. The Subcontractor recognizes that the sole source of funding for this subcontract agreement is the progress and final payments that are to be made by the Owner to Contractor. Subcontractor expressly recognizes and accepts the risk that Owner may not meet its contractual obligation to pay Contractor and that Contractor will not be liable to Subcontractor for Owner’s failure to pay Contractor.”

This is a rock solid paid when/if clause under the Court of Appeals’ holding in the *L. Harvey Concrete* case, the most recent holding on paid when/if clause.

Contractors should seek to include paid when/if clauses in their subcontracts, or to incorporate them into the subcontracts by including them within master contracts. Conversely, subcontractors and suppliers should seek to negotiate a paid when/if clause out of any prospective subcontract in order to protect their rights to timely and complete payments for work performed. If such a clause cannot be removed, subs and suppliers should independently investigate the financial stability of a project owner, and weigh the risks before proceeding.

ROC ‘NO PAY’ COMPLAINTS

Licensed contractors must pay most construction monies when due, or face discipline to their contracting license from the ROC. Under A.R.S. § 32-1154(A)(11), a contractor’s license may be suspended or revoked for:

“Failure by a licensee or agent or official of a licensee to pay monies in excess of seven hundred fifty dollars when due for materials or services rendered in connection with the licensee’s operations as a contractor when the licensee has the capacity to pay or, if the licensee lacks the capacity to pay, when the licensee has received sufficient monies as payment for the particular construction work project or operation for which the services or materials were rendered or purchased.”

A “No Pay” Complaint to the ROC can be efficient and effective. But ROC Complaints also have limitations. The table below compares the advantages and dangers of an ROC Complaint.

PROS AND CONS OF ROC COMPLAINTS

PROS	CONS
Very inexpensive	Can be time-consuming
Usually no need for attorney	Legal fees not recoverable
Complaints are free & easy to complete and file with ROC	No interest will be awarded unless provided in contract
Generally a relatively quick process (1 to 6 months)	Increases risk of counter-complaint by opposition
Two year statute of limitation	Statute of limitation is firm

Complaint forms can be completed online at azroc.gov. Before filing any complaint with the ROC, first ensure that the contractor is licensed. Filing an ROC complaint against an unlicensed contractor is worse than futile, and can potentially subject a licensed contractor to discipline. Also recognize that, while an unlicensed contractor cannot maintain a ‘no pay’ complaint, the mere filing of such a complaint is at times enough to prompt an investigation into whether a licensed contractor contracted with an unlicensed one. This is illegal, and could subject the licensed contractor to discipline and/or prosecution.

Additionally, be prepared to supply the ROC with the relevant contract(s), subcontract(s), and invoices to prove that monies are owed. If the matter proceeds to a hearing before the Office of Administrative Hearings (OAH), be sure to review the material presented on the OAH website, located at azoah.com.

When properly used, a ‘no pay’ Complaint to the ROC can be an effective tool for collecting construction monies, as few contractors are willing to risk their contracting license in the face of a legitimate Complaint to the ROC.

LIEN CLAIMS

When properly perfected, a lien claim can be the most persuasive method of collecting construction monies from a project owner. A mechanics lien is an encumbrance or charge against the real property that secures certain construction-related obligations or debts. Mechanics and materialmens’ liens exist to prevent the unjust enrichment of a property owner at the expense of those whose labor or material increased the value of the property. Once perfected, a lien can be judicially foreclosed, and the property sold to satisfy the debt secured by the lien. It is this ability to secure construction receivables through an interest in the property itself that makes liens such a powerful collections tool.

As powerful as liens can be, they are also strictly regulated. As shown in the table below, not every contractor or supplier is entitled to record a lien.

WHO MAY RECORD A LIEN

Can Lien	Can Not Lien
General Contractors	Unlicensed contractors
Subcontractors, except on owner-occupied dwellings	Improperly licensed contractors
Suppliers	Suppliers to suppliers
Architects, engineers, surveyors, other design professionals	Unregistered or improperly registered design professionals

Even if a contractor or supplier is otherwise entitled to lien, other important limitations may apply. If performing labor or supplying materials to an owner occupied residence, the only those with a contract directly with the owner have lien rights. An owner occupied residence is any residential construction project where the owner of the property intends to occupy the residence for two years. This encompasses many, but not all, single family residential construction projects.

Even assuming that a contractor does possess lien rights, other hurdles must be cleared. The first is a 20-Day Preliminary Lien Notice, or pre-lien. A pre-lien must be filed within twenty (20) days of furnishing the material, labor, or services described in the notice. While it is preferable to file a pre-lien within 20 days of first furnishing the material, labor, or services, it is not absolutely necessary to do so, provided that the 20 Day Notice covers only material, labor, or services provided within 20 days prior to its filing. A pre-lien is served by certified mail or by a Certificate of Mailing. It is served on the owner, original contractor, lender, and anyone the filer is in direct contract. Although a contractor may choose to copy the statutory language and serve the pre-lien itself, this is neither advisable nor economical in most cases. Schern Richardson recommends using a reputable lien service to file pre-liens. Using a lien service is

preferable, as a good lien service is inexpensive (usually between \$20 and \$35, depending on volume), will keep you up to date on deadlines to record a lien and foreclose, and have Errors & Omissions insurance coverage in the event it makes a mistake. This is especially important, because Preliminary 20-Day Notices are not actual liens, and will not guarantee payment. A pre-lien simply preserves your right to later record a mechanics lien with the county recorder. Not filing a pre-lien is fatal to a mechanics lien claim: No pre-lien, no lien rights. Moreover, a pre-lien must follow the statutory form, or risk being ineffective.

What comes after the filing of a pre-lien? If a Preliminary 20-Day Notice is properly filed and lien rights are preserved, the next step is to record a mechanics lien to collect unpaid construction monies. Like the pre-lien, the mechanics lien is also subject to strict time requirements. Normally, a lien must be recorded within 120 days of project completion. If a Notice of Completion has been recorded on the project, that time period is shortened to 60 days of the record date. The Notice and Claim of Lien, the language of which is also set forth by statute, should be recorded with the county recorder in the county where the jobsite is located. It must then be sent to all those with an interest in the property within a “reasonable time” thereafter, via certified mail.

Once recorded, the contractor, subcontractor, or supplier has 180 days to foreclose on its lien. Foreclosure requires filing a lawsuit in the Superior Court for the county where the property is located. A Notice of Lis Pendens must also be filed with the Superior Court and recorded with the County Recorder. The Notice, which provides presumptive notice of the litigation to all those interested in the property, must be recorded within 5 days of filing the foreclosure suit.

PROS AND CONS OF LIEN CLAIMS

Pros	Cons
Pre-lien puts gives notice that you are serious about getting paid timely and completely.	No cons to filing a pre-lien. Sophisticated owners know to expect them.
Successful lien claimants are entitled to 18% interest on monies owed.	Recording a mechanics lien can be costly (\$250 to \$1000)
Successful lien claimants are entitled to their attorneys’ fees.	Legal counsel is almost always required to foreclose a lien.
A valid lien provides a right to payment secured by the property itself.	All documents must be accurate, or lien rights may be waved.
A valid lien usually leads to a favorable settlement.	Can be a lengthy process when not promptly settled.

Recording a wrongful lien can subject the individual or entity responsible to substantial damages, including \$5,000 or treble the actual damages caused to the property owner, plus costs and fees.

STOP NOTICES

A Stop Notice is a notice served upon a project owner and project lender, instructing the owner and lender to withhold further payments to the prime contractor. A Stop Notice can be effective even where the claimant is not in direct contract with the prime contractor. In that instance, the owner will withhold money from the prime contractor, who will in turn withhold money from the subcontractor owing the claimant. Note that the requirements for filing a Stop Notice are the same as that for recording a lien. A claimant must have filed a timely 20-day Preliminary Lien Notice. Prime contractors cannot file a Stop Notice, for obvious reasons. Stop Notices can only be filed on private projects that are not owner occupied residential construction.

The procedure for serving a Stop Notice is also similar to lien claims, but there are important exceptions. An action against an owner or lender to enforce the claims stated in a Stop Notice may be commenced ten (10) days after filing the Notice, but not later than three (3) months after the expiration of the period within which lien claims must be recorded. As with a lien claim, attorneys' fees and interest are recoverable in a successful Stop Notice claim. Likewise, any person who files a false Stop Notice is subject to a civil penalty of \$5,000.00 or treble the owner's actual damages, plus costs and fees.

CIVIL COURT ACTIONS

In addition to lien foreclosures, civil courts can handle a number of other actions for collecting construction receivables. These actions include breach of contract, unjust enrichment, and violations of the Prompt Pay Act. Fraud can also be claimed, but is by its nature difficult to prove.

A breach of contract claim is relatively self-explanatory; however, note that not all breaches justify terminating a contract. If another party to a contract breaches, it is vital to determine the magnitude of the breach, and whether termination is justified, or merely to put the other party on written notice of the breach, and reserving a claim for damages. Be aware the contract language often specifies how claims for breach and damages must be handled.

Unjust enrichment is a claim often made in tandem with one for breach of contract. Unjust enrichment is an equitable method to allow recovery where there is not a valid contract. Unjust enrichment requires that the other party (usually the project owner or a prime contractor) was enriched, that the claimant was impoverished, that the enrichment and impoverishment were related, and that there is no other recourse available for collection. An unjust enrichment claim can be made by a subcontractor or supplier against an owner who has not paid for materials or labor.

Note that damages are determined by the reasonable value of the labor and materials supplied.

The Prompt Pay Act has already been discussed. Fraud claims are very difficult to plead and prove in most cases. Payment bond claims, which are also made in Superior Court, are discussed below.

PROS AND CONS OF CIVIL ACTIONS

PROS	CONS
A suit for breach of contract, if successful, entitles the plaintiff to its full damages, both actual and consequential	Generally very expensive. Almost always requires hiring legal counsel for lawsuits in Superior Court.
Successful breach and/or Prompt Pay Act claimants are entitled to their attorneys' fees.	Can take a very long time to recover the full amount owed; average between 9 to 36 months.
Successful breach and/or Prompt Pay Act claimants are entitled to their interest.	Runs the risk of bankrupting yourself, or the other side, in the process.

Civil lawsuits usually require large amounts of both time and money. But this is not always true. Smaller cases, for damages below \$15,000, can be heard in Justice Court, where the average wait time is much less, and where a lawyer is not always required. However, note that a corporation must be represented by an attorney, even in Justice Court cases. When considering a civil suit, analyze the operative facts, the applicable claims, and the amount of likely damages before choosing what court to file in. Consulting with an experienced construction or contract law attorney is almost always worthwhile.

PAYMENT BOND CLAIMS

What is a payment bond? Payment bonds are a substitute form of security for persons providing labor or materials on public works projects, on which lien rights are not available. A payment bond is executed by a surety company, which promises to pay a proper claimant on the bond.

The requirements for making a bond claim are different than those for a lien claim. The prime contractor does not need to file a 20-Day Preliminary Lien Notice to have bond claim rights. Subcontractors in direct contract with the prime contractor do not need to file a pre-lien to secure bond claim rights, but Schern Richardson recommends always filing a pre-lien. All lower tier subcontractors and suppliers must file a 20-Day Notice to have bond claim rights.

There are important time limitations for making a bond claim. Lower tier subs and suppliers making bond claims must give written notice to the prime contractor via certified mail within 90 days of the last date that labor was performed or

materials were supplied to the project. The notice must specify the amount owed, the labor or materials supplied, and to whom they were supplied. Once the 90 days expire, the bond claimant may file a lawsuit in Superior Court naming the owing party and the bonding company as defendants. Prime contractors and subcontractors must also wait 90 days after the date they last furnished labor or materials before filing suit. While not absolutely necessary, Schern Richardson strongly recommends sending a 90 day notice as well to the owner and bonding company, prior to filing suit on the bond.

Once all notice requirements have been met, a bond claim is made in civil court just as any other cause of action. The pros and cons are identical to those previously discussed, as are the damages, including fees and interest.

SUMMARY

This guide offers a brief overview of avenues for collecting construction monies. There are no hard and fast rules on which avenues are best pursued in every case; rather, each project must be evaluated to determine which method or methods offer the most efficient and effective protections. For example, relatively small projects might not warrant pursuing a lien or a Superior Court action, but might warrant a Justice Court Complaint or an ROC Complaint, if the owing party is a licensed contractor.

The best suggestion is to have systems in place to ensure that you are protecting your rights to be paid for your work. In essence, do your paperwork! Utilize construction contracts with favorable terms while avoiding being subject to paid when/if clauses. Contracts are a compromise; you do not have to agree to bad terms. Always file a pre-lien, but never record an invalid lien. Document change orders and resist the temptation to perform work on a verbal change order. Most importantly, call an experienced construction law attorney for contract and other construction law questions, not your estate planning or divorce lawyer. Each area of law is like a specialized trade, and consulting a qualified construction law attorney helps ensure that the advice you receive is tailored to the construction industry.

In the end, the best defense is a good offense. Understand the collection methods described herein. Be diligent and proactive about protecting your construction receivables, and you will be collecting more of your construction monies, more of the time.

This guide is presented for general informational purposes only. It is not intended as, nor should it be relied on for, specific legal advice. Consult a qualified construction law attorney with questions about your own situation, and to determine changes to applicable laws and regulations.

ABOUT THE AUTHORS

Schern Richardson, PLC was founded in 2006 from several of the Valley's most knowledgeable and respected attorneys. An agile, dedicated legal group, the Firm's practice is devoted to construction, contract, and business law. The Firm represents contractors, subcontractors, suppliers, and design professionals in all types of construction-related disputes.

The Firm's attorneys represent contractors in judicial and administrative proceedings throughout the State of Arizona. Its clientele is largely contractors, although the Firm has substantial experience representing project owners, suppliers and lenders.

Construction receivables are worthless... *unless* they can be collected.

Collecting your construction monies can be one of the most difficult aspects of being a contractor. It should be simple, but collections can be as complex as the most demanding set of plans and specifications. This guide offers a brief overview of 7 common techniques for collecting your construction receivables, including:

- ◆ Arizona's Prompt Pay Act
- ◆ Contractual Payment Terms
- ◆ 'No Pay' Complaints to the Registrar of Contractors
- ◆ Mechanic's Lien Filing, Perfecting, and Foreclosure
- ◆ Construction Stop Notices
- ◆ Civil Court Claims
- ◆ Payment Bond Claims

The guide also offers important considerations for determining which collection techniques are appropriate for different situations, and tips on how to best protect your right to payment for your construction work. A proper understanding of each collection method--and when to use it--is an essential tool for ensuring that your contracting business not only survives, but thrives.

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