



# QUARTERLY CONSTRUCTION BRIEFS

## ATTENTION BONDED CONTRACTORS: *Take Steps to Avoid Paying Twice*

### Dear Friends:

With the ever-changing environment of our industry and the speed at which it changes, we feel it important to communicate to you critical topics that affect you and your business. This article is an example of one of those issues.

► **Karen Mummert, Greg Marco and Tim Ziegler**

The potential exposure to payment bond claims by downstream suppliers recently increased thanks to a surprising decision by the Pennsylvania Commonwealth Court. On Pennsylvania public works projects, neither a prime contractor nor its surety ever had to pay a supplier twice. If the prime contractor paid the subcontractor – but that subcontractor failed to pay its subs and suppliers – the subs and suppliers were usually out of luck and had no claim upon the payment bond. Therefore, prime contractors on public projects had no real need to make sure subcontractors actually used funds to pay their own subcontractors and material suppliers. The Pennsylvania Prompt Payment Act, which governs payment obligations on public projects, contains the following provision:

*Once a contractor has made payment to the subcontractor according to the provisions of this sub-chapter, future claims for payment against the contractor or the contractor's surety by parties owed payment from the subcontractor which has been paid shall be barred.*

This is known as the “safe harbor” provision of the Payment Act. If a downstream supplier (or subcontractor) files a claim on the payment bond, the surety and bond principal (i.e. the prime contractor) are “safe” – that is, they don't have to pay the claimant if the contractor can prove it paid the sub or supplier. Under the

safe harbor provision, if a contractor hired a rogue subcontractor which failed to pay its bills, the surety was not liable for the unpaid bills as long as the prime contractor it had made payment to the subcontractor. Since the second-tier entities had no contract with the prime contractor, no right to file a lien and no claim on the bond, the prime contractor did not have to pay them.

Thanks to the recent court decision in *Berks Products Corp. v. Arch Insurance Co.*, 2013 Pa. Commw LEXIS 254, however, contractors and sureties can no longer assume that the safe harbor provision of the Payment Act will prevent them from having to pay twice. Unless the payment bond form expressly includes safe harbor type language, the surety will have to pay second-tier subs or suppliers even if the principal (the contractor) paid its subcontractor. Before paying the claim, the surety will demand that the contractor pay the claimant. The standard language used in most payment bond forms on public projects will have to be revised. Otherwise, sureties and the contractors they bond will run the risk of paying second-tier suppliers and subcontractors of a rogue sub who failed to pay its bills out of payments previously received.

While bonding companies work on revised language, the most important step contractors can take is to require that their subcontractors provide waiver/release forms in exchange for each payment. A waiver/release should be required not only for the subcontractor, but for each of its subcontractors and suppliers as well. The second-tier sub or supplier must certify in the waiver/release form that it received all payments previously due. This will severely reduce the amount of the payment bond claim or eliminate it altogether. While collecting releases from second-tiers is administratively burdensome, it beats having to pay a large bill a second time. Another option is to make all payments via joint checks to ensure that suppliers and subcontractors are paid.

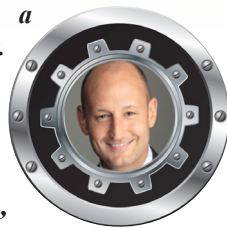
Either way, it is important to know all potential claimants on the payment bond. Therefore, prime contractors are well-advised to require each

subcontractor to identify and disclose all subs and suppliers that they will be using on the project. Contractors who bond projects should review their subcontracts with counsel to make sure they have the contractual right to demand this information from the subcontractor, including the right to make payment via joint check, or by direct payment if necessary. If the contract does not expressly permit these things, demanding them could be a breach of contract.

In this sputtering economy, bankruptcies and insolvencies at the subcontractor level are still high. Financially insolvent subcontractors that disappear often leave a trail of unpaid subs and suppliers that can wreak havoc with bond claims. Don't be caught off guard - take steps now to avoid the catastrophe of having to pay twice.



*Mr. Woolford is a construction law attorney. His law firm, Woolford Law, P.C., represents construction professionals in all aspects of the construction process, including project planning and approvals, contract preparation and negotiation, consultation on day-to-day construction issues, claims preparation and defense and dispute resolution. Mr. Woolford is a frequent contributor to regional and national construction-related publications and regularly speaks on important construction-related topics. He is also an Adjunct Professor of construction law at the Penn State University Dickinson School of Law. Mr. Woolford received his B.A., from the University of Michigan in 1991 and his J.D., from The Dickinson School of Law in 1996.*



For more information about McConkey's Construction Program, contact:

Tim M. Ziegler, CRIS ■ PH: 717-505-3153 ■ [tziegler@ekmconkey.com](mailto:tziegler@ekmconkey.com) ■ [ekmconkey.com](http://ekmconkey.com)