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New York's new law on construction contracts

On July 18, 2002, the New York State Legislature added a new Article 35-E (§§756-758) to the General Business Law which governs when and under what circumstances Owners, Contractors and Subcontractors (defined) must pay or may withhold payments due, respectively, Contractors, Subcontractors or Material Suppliers on a construction job. The new law went into effect 180 days after its passage, *i.e.,* on Jan. 14, 2003 ("Effective Date"). It applies to all Construction Contracts (defined) which are entered into on or after the Effective Date for work which is first begun after the Effective Date where the work, equipment or service equals or exceeds $250,000.00. Generally, the new law applies to non-public commercial and large residential development projects in New York State.[1] §757 makes void any contract provisions (except with a Material Supplier) which subjects the Construction Contract to the laws of a state other than New York or requires a dispute resolution to be held outside New York State.

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The stated purpose of the law is to ensure that Contractors, Subcontractors and Material Suppliers get prompt payment for their work. Chapter 127 §1. The positives and negatives of the law will depend on the hat you wear, *i.e.*, Owner, Contractor or Subcontractor. Generally, the new law provides that persons responsible to pay under a Construction Contract (an Owner, Contractor or Subcontractor) have 12 business days to approve or disapprove in writing any part or all of an invoice submitted for work performed by the payee (Contractor, Subcontractor, Sub-subcontractor or Material Supplier). §756-a 2(a)(i) and (ii). "Unless otherwise agreed," any undisputed amounts must be paid by an Owner to a Contractor within 30 days following the approval/disapproval deadline (*i.e.,* within 42 days after submission of the Contractor's invoice). §756-a 3(a)(ii).[2] The Contractor in turn must pay the Subcontractor and the Subcontractor must pay its Sub-subcontractors and Material Suppliers all undisputed amounts within seven days of receipt of funds. §756-a 3(b)(ii).

If the payor disapproves an invoice, it must describe in writing the items that are not approved. However, there does not appear to be any requirement for the **Owner** to disclose why it is withholding payment for the items identified, although, it is subject to obligations of "good faith" and "reasonableness". There also does not appear to be any obligation on a Subcontractor to disclose why it is not paying its Sub-subcontractors or Material Suppliers.[3]

A Contractor, on the other hand, who withholds from a Subcontractor must, "as soon as practicable upon ascertaining the cause," furnish the Subcontractor in writing with the reasons for withholding, the amount withheld and the remedial actions necessary to be taken by the Subcontractor in order to receive the withheld amounts. §756-a 3(b)(iv)(i) and 3(c). This is an important benefit for Subcontractors as it will prevent Owners and Contractors from arbitrarily withholding payments and, when sued later, claiming some deficiency that, if timely known, could have been promptly cured.

The new law provides for simple interest at 1 percent per month on any payments that are delayed beyond the due date. §756-b 1(a) and (b). The statute refers to interest on the "unpaid balance." It is unclear from the language of the statement whether this interest only accrues on money determined to have been wrongfully withheld or whether it accrues on all unpaid balances which may have been initially rightfully withheld but later paid when the reason for withholding (*e.g.*, a Contractor's default claim against a Subcontractor) has been resolved. It is submitted that interest should accrue only for monies wrongfully withheld, otherwise, a contractor or subcontractor could submit a requisition for work which he/she has never done and start the interest meter running though there was never a right to payment.

The new law also provides that if an Owner fails to approve or disapprove a Contractor's invoice within the 12 day time limit, the Contractor may suspend work on 10 days' written notice. §756-b 2(a). Similarly, if the Owner fails to approve or disapprove or pay the Contractor within the required time limits **or** if the Owner has paid the Contractor but the Contractor has failed to pay the Subcontractor within the required time limits, the Subcontractor may suspend work on 10 days prior written notice to the Owner and Contractor. §756-b 2(b). Any contrary contract provision in the prime contract or the subcontract is void. §757(2).[4]

§756-c of the new law limits the amount of retainage an Owner may retain against deficiencies or that a Contractor or Subcontractor may withhold as to its contract party to a "reasonable amount of the Contract sum," provided that the amounts retained by a Contractor or Subcontractor cannot exceed the percentage retained by the Owner. In addition, any retainage must be released by the Owner to the Contractor within 30 days following

final approval of the work or simple interest accrues at 1 percent per month. *Id.*

The new law is not without its difficulties and uncertainties. Its intended remedial purpose to ensure timely payments to Contractors and Subcontractors is undercut somewhat by the failure of the new law to clearly require written explanation of reasons for nonpayment by the Owner. The most troubling provision of the new law, however, is language which only refers to payments by a Contractor to a Subcontractor after the Contractor receives funds from the Owner. The only provision in the new law providing for payment to Subcontractors provides that "when a Subcontractor has performed in accordance with the provisions of its Construction Contract, the Contractor shall pay to the Subcontractor . . . the full or proportionate amount of **funds received from the owner** . . . ." §756-a 3(b)(ii) (emphasis added). This language could be argued to be legislative approval of the "pay when paid" provisions found in many construction contracts, which have heretofore been stricken by the courts as void against public policy. *See, e.g., West Fair Electric Contractors vs. Aetna Casualty & Surety Co.,* 87 N.Y.2d 148, 638 N.Y.S.2d 394 (1995) (private construction job; provision in subcontract making payment to subcontractor expressly conditioned on payment by owner to contractor, void as against public policy). Unlike payment by the Owner to the Contractor, which is expressly subject to the terms of their contract, §756-a 3(a)(ii), payment by the Contractor to the Subcontractor is not so expressly conditioned under the statute. §756-a 3(b)(i).[5]

It may be that even if the Subcontractor has performed all his work, if the Owner withholds further payments from the Contractor because the Owner goes bankrupt or due to the Contractor's default for which the particular Subcontractor is not responsible, the Subcontractor may have difficulty collecting directly from the Contractor or from its surety under the latter's payment bond (the surety will take the position that its liability is only coextensive with its principal's (Contractor's) obligation to pay). That is an argument a Contractor or surety can be expected to raise when the Owner, for whatever reason, refuses to pay.[6] Other commentators have recognized this possible interpretation. *See, e.g.,* Czik, "New Contracts Act May Reawaken Pay-When-Paid Defenses," NYLJ, 2/19/03, p.4, col. 3 (hereinafter "Czik"). However, the intent of the statute is to ensure prompt payment of Contractors and Subcontractors. It is submitted that in view of this remedial purpose and the absence of an express intent to overrule cases such as *West Fair*, such an intent should not be inferred. Rather, the "pay when paid" provisions of the statute should be viewed simply as an additional minium remedy which requires, for example, payment to Subcontractors within stated time periods whenever the Contractor receives its funds, but does not require such prior payment to the Contractor before the Subcontractor is entitled to payment for work done.

In yet another provision, the new law expressly appears to validate provisions in Construction Contracts which recite that the Contractor is simply an agent for an Owner who is a disclosed principal. §756-a 3(b)(i). Under general contract law, an agent is not responsible for the contractual obligations of a disclosed principal who is the liable party, unless there is an express agreement to hold the agent liable as well. The "agent for disclosed principal" provisions in construction contracts have previously been stricken by the courts as disguised "pay when paid" provisions which unfairly shift the risk of the Owner's insolvency or breach on the Subcontractor who is a stranger to the Owner. *See, Blandford Land Clearing Corp. v. National Universe Fire Ins. Co.,* 260 A.D.2d 86, 698 N.Y.S.2d 237 (1st Dept. 1999) (private construction job; provisions in subcontract making contractor only agent of owner and providing that subcontractor was relying solely on owner's credit, void). The language in the new law could be argued to validate that type of clause, thereby providing another loophole for the Contractor and its payment bond surety. *See*, Czik, *supra*. Again, such an interpretation would appear to be contrary to the legislative intent which appears in §1 of the statute. Section 756-a 3(b)(i), the provision which appears to validate an agent-for-disclosed principal agreement and which would otherwise exonerate the Contractor, provides that the payment obligation "shall flow directly from the disclosed owner as principal to the subcontractor and through the agent." It is submitted that this provision simply means that in agent-for-disclosed principal contracts, **both** the Owner and the Contractor shall be directly liable to the Subcontractor.

Another ambiguous area of the new statute is the remedy of stopping work after 10 days written notice (§756-b). Such remedy may not be sufficient to prompt a recalcitrant Owner or Contractor to resume payments. If the alleged default or deficiency is great enough and the Owner's allegations are arguably sustainable, the Owner or Contractor may simply let the job go to a substitute Contractor or Subcontractor at a lower price and take its chances with the original Contractor or Subcontractor in court. This remedy may also be of little help if the money being withheld is at the end of the job and there are no specific warranties that need to be provided. Further, it is unclear whether the remedy of stopping work after 10 days notice following the period when payment is due is intended to be exclusive of a Contractor's or Subcontractor's contractual or common law right to stop work for non payment as a material breach of its contract. It is submitted that the statutory remedy is not meant to override either a contractual or common law remedy to stop work.[7] Although, in order to invoke either a contractual, common law or statutory remedy to stop work, a Contractor or Subcontractor must show that it did its work and is entitled to the withheld payment, the statutory remedy should be viewed as a "safe harbor," so that by following the statutory procedure a Contractor or

Subcontractor need not gamble that the Owner or Contractor will claim that its stoppage of work was precipitous and wrongful and that the failure to make payment promptly was simply a reasonable, excusable administrative delay, not a material breach. Where a Contractor or Subcontractor properly stops work under the statutory scheme, contract completion deadlines are extended for the period of time lost between stoppage and ultimate payment. §756-b 2 (b)(iv).

Although it is not entirely free from doubt under the new law (*see,* note 5, *supra*), a Contractor or Subcontractor should argue that the payment provisions of the new law are intended to be subject to the provisions of the applicable Construction Contract except where the new law expressly declares such contract provision "void" and that the statute will operate when a Construction Contract is silent on an issue. Nevertheless, rather than deal with the ambiguities of the statute, the best approach is to ensure that properly negotiated provisions are included in the Construction Contract which eliminate "pay when paid" and "agency" clauses (or modify the "agency" clause to make it clear that the agent (Contractor) remains liable) and that the contract ensures a mechanism for prompt specification of deficiencies and required remedial action. In that way Contractors, Subcontractors and Material Suppliers should be able to retain the benefits of the new law while avoiding its possible pitfalls.

As with any new statute, these observations, queries, and issues will be refined by challenges in the courts. At a minimum, the law requires attention by all those involved in commercial construction in New York.

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1. Rather than state what contracts the law embraces, the law states instead what contracts are not included. The new law does not apply to Construction Contracts for (1) public improvement projects; (2) individual one, two or three family residential dwellings; (3) residential tract development for one or two family dwellings of 150 units or less; (4) any residential project of 9,000 square feet or less; or (5) certain publicly funded low income housing project of less than 150 units. §756(1). Nor does the new law apply to construction contracts for the reconstruction of lower Manhattan arising out of the terrorist attacks of September 11, 2001. §756-e

2. If payment is contingent on lender approval, the Owner has seven days to pay after receipt of lender's funds, §756-a 3(a) (iii), provided the Owner makes "timely" application to the lender for disbursement. §756-d(2).

3. §756-a 2(i) lists six reasons for which an Owner may withhold from or disapprove a Contractor's invoice. In only one of these (architect's failure to certify payment) must the Owner include the reasons in its written statement of disapproval. The limitation of the requirement to set forth reasons solely in the case where an architect fails to certify is probably just an oversight for, as a practical matter, if an Owner refuses to pay, it will probably always be as a result of its architect's advice and, if not, failure to set forth reasons will open the Owner up to a charge of bad faith and unreasonableness. Moreover, during the course of construction, the Owner, Contractor, and Subcontractor will meet on a regular basis to discuss problems, change orders and punch list items. When a Contractor or Subcontractor's invoice has not been paid in full, the unpaid parties will move quickly to demand such meetings to resolve any objections.

4. Since the Owner has 42 days within which to pay the Contractor and the Contractor has seven days within which to pay the Subcontractor, this would appear to mean that a Subcontractor could be required to continue work for almost two months (59 days) after submitting an interim invoice which remains unpaid.

5. *See also*, §756-a ("Except as otherwise provided in this article, the terms and conditions of a construction contract shall supersede the provisions of this article. . ."). Similarly §75b-a 3(b) provides that the payment provisions of the contract between the Contractor and Subcontractor or the Subcontractor and its sub-subcontractor will control "[un] less the provisions of this article provide otherwise . . ." *Query*: As to a Subcontractor, is the requirement of payment by the Owner to the Contractor an example of "Except as otherwise provided in this article . . . "?

6. §756-a 2(b) purports to prohibit an Owner or Contractor from withholding payments to a Subcontractor due to "delays" in job progress not due to that Subcontractor's fault. However, many times an Owner will withhold funds from a Contractor for delay without knowing or specifying which of the Contractor's several Subcontractor's caused the delay. Indeed, all of the Subcontractors may be blameless, and the Contractor may be solely at fault for delay, e.g., because it started the job late or failed to properly supervise and coordinate the trades. There is nothing in the new law that says the Contractor must pay the Subcontractor even if the Contractor is not paid by the Owner, and if the Owner withholds payment to the Contractor because of "general" delay, the Subcontractor may still have difficulty getting paid.

7. As to a contractual right to stop work, the statute provides that "except as otherwise provided in this article" the parties' contract controls. §756-a. Again, it may be argued that the statutory remedy is the "except as otherwise provided." However, for the reasons set forth above, it is submitted that the statutory remedy is in addition to any contractual right. That raises the issue as to what happens if the contractual provision causing stoppage of work is narrower than the statutory remedy or prohibits stoppage of work entirely. Presumably, because such a contractual provision is not referred to in §757 (Void Provisions), such a provision would control and supercede that statutory remedy.