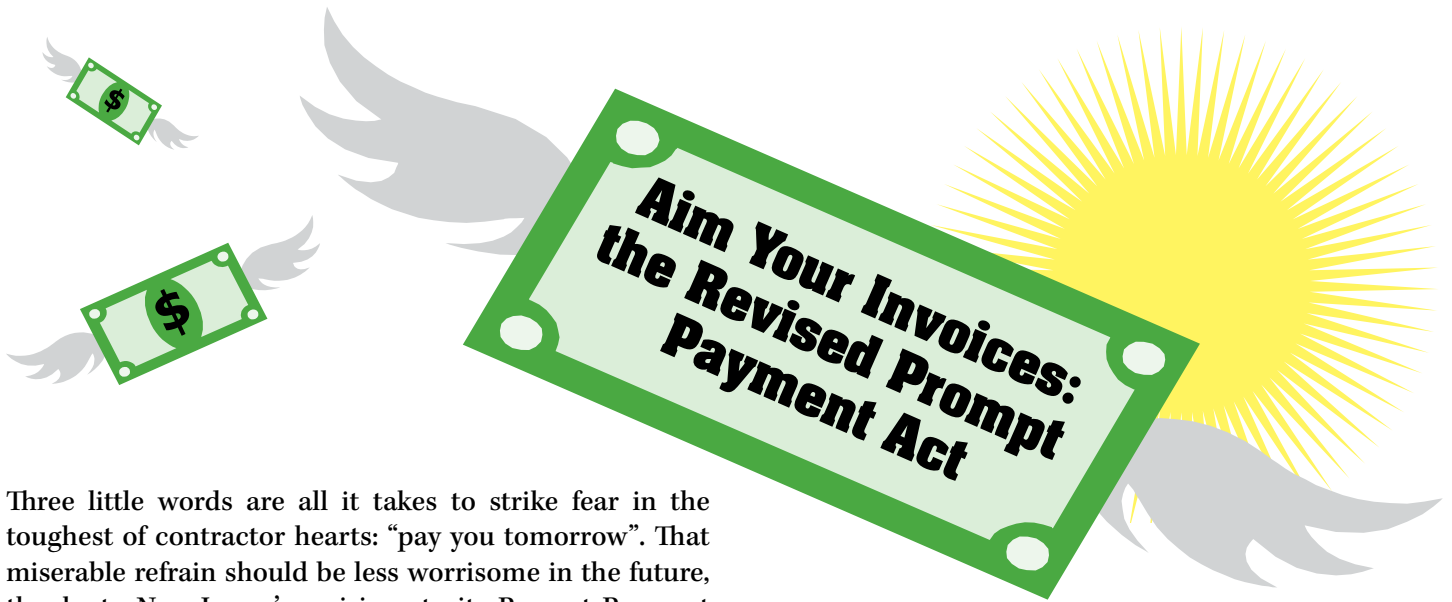


**This Issue:
Special
Prompt
Payment
Act Edition**

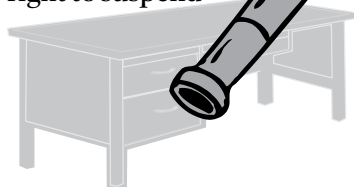
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Three little words are all it takes to strike fear in the toughest of contractor hearts: “pay you tomorrow”. That miserable refrain should be less worrisome in the future, thanks to New Jersey’s revisions to its Prompt Payment Act (the “Revisions”). But like any law, the Revisions have their limitations. Due to their potential importance, this issue is being dedicated to a practical explanation of the Revisions and how to use them to a contractor’s best advantage.

In broad terms, the Revisions toughen a contractor’s payment rights by giving the industry the power to extract stronger penalties for nonpayment. For the first time, project owners must pay specified interest on undisputed debts and do so at a higher rate than courts would likely grant. Subcontract rights have been strengthened; there is now a statutory right to suspend



performance, and as a new mandate, all contracts are supposed to contain clauses which require mandatory alternative dispute resolution, or ADR.

The reason why there are “Prompt Payment Acts” around the country is because the legal system’s home-grown remedies have not been very effective. Originally, interest recovery was not ordinarily granted by judges unless a contract provided for it. Now, courts will usually grant interest because they recognize that it represents a contractor’s lost use of money for which it ought to be compensated.

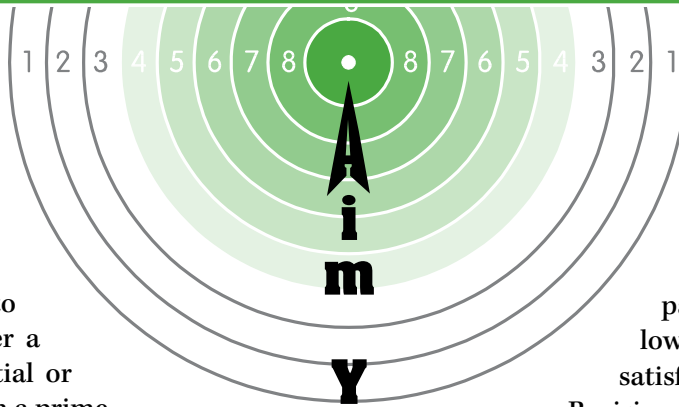
Unfortunately, the court system remains conservative and lawsuits too expensive to fund for this loss. Without a contract right, the courts usually pick a low rate of return and do not permit recovery of counsel fees. For example, if payment of \$100,000 is delayed for one year, a court might only allow an interest rate which is worth about \$3,000. A similar problem exists when trying to recover retainage. If the contractor must spend over \$20,000 in legal fees, and cannot recover them back, the money is lost. Furthermore, an unpaid contractor may have the right to suspend performance for nonpayment, but the

Please continue on page 2

risk of being terminated and restrictions in most construction contract forms against suspension make it a dangerous option.

To remedy these problems, the Revisions are structured to follow the flow of funds. After a project owner receives a partial or final payment application from a prime, design professional, or some other applicant, the owner ordinarily has 30 days to tender payment. The claimed amount is "deemed approved and certified" unless a written "withholding statement" of the withheld amount and the reasons for withholding are received by the applicant within 20 days. In the remaining 10 days, the undisputed portion must be paid. Otherwise, the Owner is liable for interest at the prime rate plus 1%. The Revisions also have a special exception for public bodies. This permits a bid specification to approve payment at the next public meeting, with payment during the "subsequent payment cycle." The Revisions do not otherwise permit an Owner to modify the payment period or the statutory rate of interest.

Once a prime or design professional receives payment, the amount due a lower "tier",

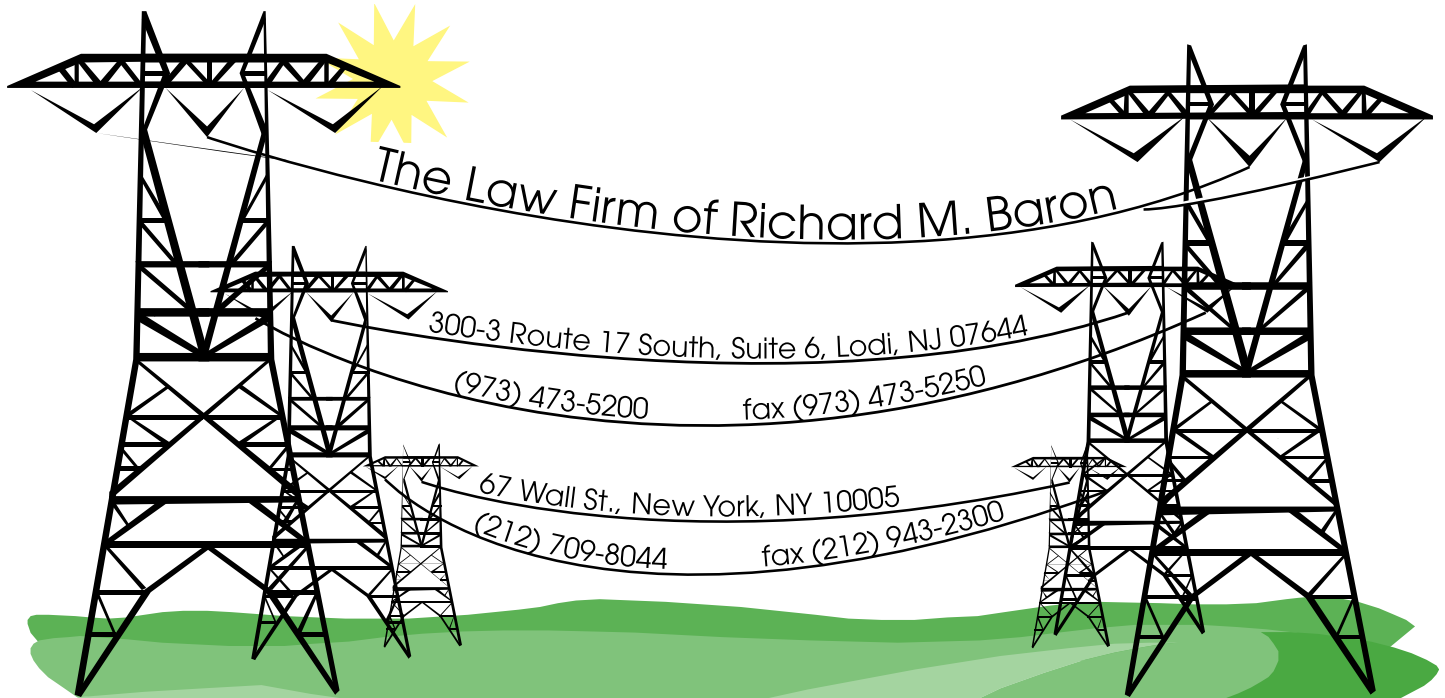


Aim Your Invoices

like a sub, must ordinarily be paid within 10 days. Similar obligations are owed to subs and suppliers of subs. The Revisions do allow modifications to pay periods for subs and suppliers, and payment can be withheld from lower tiers if performance is not satisfactory. In this situation, the Revisions do not give the unpaid party a right to a withholding statement.

The Revisions provide two types of remedies. First, any delinquent party must pay interest at the prime rate plus 1%. In litigation, the unpaid party can also recover its counsel fees. Second, any unpaid applicant can also suspend performance after 7 calendar days' written notice to the delinquent party except if: (1) the applicant receives a written statement of the amount withheld and the reasons for withholding, and (2) the non-payor is "engaged in a good faith effort to resolve the reason for the withholding". Note that subs and suppliers get the right to a withholding statement by threatening suspension even though this right is not otherwise available.

All contracts must now include ADR, like arbitration or mediation. The Revisions



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Construction Law: That's All

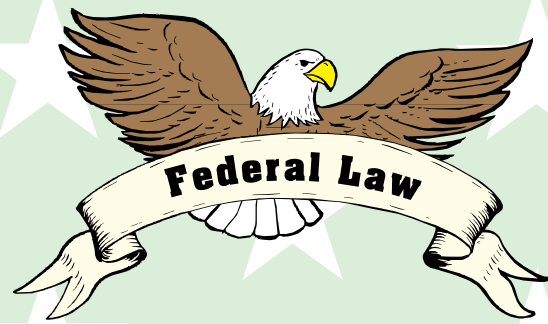
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inadvertently discourage arbitration, however, because legal fees are only recoverable “in any civil action” and arbitration is not a “civil action”. We expect the courts will eventually fix what seems like a goof-up and permit recovery, but don’t become the test case. The courts will also have to “fix” contracts which omit any ADR reference at all; we expect they will add something non-binding, like mediation.

Some additional, practical pointers should be noted. First, the Revisions require a full passthrough of the amount received for the work of each applicant. To avoid fights between subs and suppliers over violations of the law, single line items in a partial payment application should not mix the work of two firms. In addition, primes ought to be careful about front-loading a line item because a sub could claim a right to more funds from a progress payment than the work was worth. Design professionals who review payment applications should also be very careful about this role. Not only could the failure to meet the Revisions’ time limits subject them to professional liability, but the courts might decide that the omission or misstatement of a reason to withhold payment precludes that reason from being raised in the future.

To add a little more complexity to the mix, the Revisions do not apply to New Jersey contracts made before September 1, 2006. So, the construction industry will sometimes have the more limited rights available under the earlier, unrevised version of the Prompt Payment Act. Furthermore, there is a separate, more limited law governing public works contracts with the State. While its requirements so overlap with the Revisions that it will have little meaning for new contracts, it remains important for pre-September 1, 2006 agreements. To simplify matters, the three laws are all compared on the table at the end of this issue. The Revisions also have no effect on federal contracts and some federally funded projects because they are governed by the Federal Prompt Payment Act. While we had no room in this issue, New York also has “prompt payment act” requirements.

Although the Revisions are important, they should have been broader. None of the Prompt Payment Acts cover claims which are omitted from an application for payment, like disputed extras. For those situations, the construction community must seek to recover the punier interest and counsel fees rights which a court will permit. Furthermore, the interest rate should have been set at a higher point. Borrowing unsecured funds at prime plus 1% is attractive; a higher interest rate would create a greater disincentive to cheat. Nevertheless, the Revisions are a great step in the right direction. The industry deserved them earlier.



Federal contracts and some federally funded grant programs are governed by a different law known as the Federal Prompt Payment Act. While the federal version provides the model for New Jersey’s laws, there are quite a few differences.

The biggest practical differences involve the time limits for payment and the interest rates for delayed payment. Federal law ordinarily allows only 14 days for progress payments and 30 days for final payment. Progress payment applications are supposed to be reviewed in 7 days, but it can be longer if the government still makes payment during the original 14 days. If the government’s solicitation provides for it, there are rare circumstances where these time periods can be modified. Once the government pays a prime, the prime has only 7 days to pay its subs and suppliers. Subs must also pay their subsubs and suppliers within 7 days, and this obligation runs to all lower tiers. In New Jersey, the prompt payment obligation stops with the “subsub” tier.

The second biggest difference involves interest rate calculations, and here, New Jersey law is better. In 2006, for example, the average interest rate obligation for “the Feds” was slightly more than 5.5%. Under New Jersey law, the average would be closer to 8.75%.

Written withholding statements must be given to all unpaid applicants within 7 days. The Revisions only require them for subcontracting parties if they threaten to suspend performance of their work. Also, federal law does not offer a suspension “remedy” like New Jersey, and counsel fees are not owed to a party who must sue to get paid. Primes can recover counsel fees, however, under different law.

Federal law is far too broad and detailed to fully summarize here, but other topics include: interest recapture from overpayments, payment certification obligations, and the right of a government agency to claim payment discounts. The law also extends beyond construction to all government contracts.

Summary of New Jersey's Prompt Payment Laws

	Revisions to Prompt Payment Act	Original Prompt Payment Act	State Contracts Prompt Payment Act
Public works	State and local	State and local	State only
Private projects	Yes	Yes	No
Parties with rights			
(a) Contracts with owner	Yes	No	No
(b) Subs and suppliers	Yes	Yes	Yes
(c) Subsubs and suppliers to subs	Yes	Yes	No
(d) Suppliers to suppliers	No	No	No
Summary			
Payments due from project owners	30 calendar days after billing date, or public body's billing cycle	Not applicable	Not applicable
Payments due all other parties	To be paid within 10 calendar days, unless contract provides otherwise and applicant must be satisfactorily performing		
Procedure for withholding	Owner must give written withholding statement	No statement required	Must give written withholding statement and notice to surety
Interest, prime rate plus 1%	Legal rate cannot be waived by contract	Legal rate may be waived by contract	Probably cannot be waived by contract
Right to suspend performance	Yes, after 7 days written notice and no adequate response	No, court-made law only	No, court-made law only
Supercedes other laws	Yes, if rights greater under this law	No	No
Mandatory ADR clause	Yes, but no penalty if omitted	No	No
Court costs and attorneys fees	Reasonable costs and attorneys' fees, only in litigation	No	"Court costs" to party who wins; counsel fee recovery unclear
Applicability	Contracts made on or after Sept. 1, 2006	Contracts made before Sept. 1, 2006	Pre- and post-Sept. 1, 2006