

## Shutting Down the Construction Project

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*Trouble, in the form of adverse changes in financial conditions or the property marketing environment, sometimes strikes urban real estate development projects during the period between construction contract signing and completion of procurement and construction activities. In many cases, the course of action that will maximize value for all stakeholders is to allow the work to continue. Project completion will result in improvement to a base level and more security from casualty risks, as well as satisfaction of the conditions from a seller or redevelopment agency to drawdown of the land rights. But if financing for that continuation is not available, or if prospects for selling or leasing the improved property appear sufficiently bleak, the developer may reluctantly determine that the construction contracts and work should be suspended for some period of time or terminated altogether.*

*This article outlines significant issues that an owner should consider when suspending or terminating a California commercial construction project. Similar principles apply to projects in other states and of a residential, industrial or public nature, but the statutes and other requirements are highly technical, and the specifics of the laws and contracts should always be reviewed by counsel.*

### **Delivering the News—Notice of Suspension or Termination**

Most construction contracts include a clause conferring on the owner the right to suspend the work in whole or in part for any length of time, sometimes subject to an outside limit, as well as the right to terminate the work due to a contractor default or insolvency event or for the owner's "convenience." See, e.g., AIA A201 General Conditions, Article 14. (Termination for either side's default or insolvency, and jobs where the owner and contractor have made claims against each other, are beyond this article's scope.) The notice exercising such a right naturally should include all of the information required by the clause,

such as the effective date of the suspension or termination and instructions on whether subcontracts or purchase orders should be terminated or assigned to the owner or its designee.

In addition, the owner should consider addressing matters in the notice or in a letter agreement confirming the state of contractual rights and duties. For example, the owner might require delivery of design work product and a formal assignment of copyright or other rights in that design. If materials have been ordered or are in transit or stored offsite, the owner might require that the manufacturer, carrier or warehouse operator be notified of the assignment of rights in those materials and have the contractor acknowledge the ownership transfer. Moreover, policies of insurance may require actions based on the transfer of care, custody and control of the project site and materials.

The owner generally will seek an acknowledgment of the specific amount owing to the contractor and the conditions on which such amount will be paid. The remaining payment generally includes costs of work done prior to the effective date of the notice, plus reasonable costs of demobilization, termination of purchase orders and shutting down operations, and undisbursed retention for work properly completed. Some contracts provide that a termination for convenience requires payment of a portion of the fee that the contractor otherwise would have earned, while under other contracts no such additional fee is owing. The payment should be released only upon receipt of lien waivers and releases completed by the contractor and by its applicable subcontractors and vendors.

Under what circumstances should the owner suspend rather than terminate the prime contract? Suspension usually entails some carrying cost or standby and security services and some additional amounts payable to vendors and manufacturers. As these costs add up, the owner eventually will need to decide whether there are sufficient prospects of restarting the project or selling it to a buyer who wants the contracts to remain in effect.

### **Keeping the Contract or Subcontracts in Effect—The Prompt Payment Requirements**

If the decision only is to suspend the prime contract, or to keep the subcontracts in effect, the owner will want to observe the prompt payment statutes and the applicable contractual provisions to avoid significant late payment fees and exposure to contractor or subcontractor rights to stop work or terminate its obligations. In California, the prompt payment requirements are unhelpfully scattered across the Civil Code, the Business & Professions Code, the Public Contract Code and even the Public Utilities Code. See page 6 for a chart entitled “Prompt Payment Requirements for California Private Works,” which lists the principal mandates for progress and final payments to contractors and subcontractors.

The basic California rules are that an owner must pay the contractor within 30 days after receipt of a complete application for progress payment in accordance with the terms of the contract (Civil Code Section 8800) and must make final payment (including release of retention) to the contractor within 45 days after “completion” (Civil Code Section 8812). In the context of a suspension or termination, completion means a cessation of labor for a continuous period of 60 days or a cessation of labor for a continuous period of 30 days if the owner files a “notice of cessation” in the county land records (Civil Code Sections 8180, 8188, and 8190).

However, the exceptions to these basic rules arguably are more important than the rules themselves, especially to an owner trying to limit its exposure to unwarranted payment requests. The prompt payment timetables are not triggered until the owner receives a complete application for payment in accordance with the terms of the contract. For example, if the contract requires the contractor to submit conditional and unconditional lien waivers with each application for payment and such items are missing from the

contractor's submittal, the owner is under no obligation to make the requisite payment. If the owner disputes whether an item of work was performed properly, up to 150 percent of the disputed amount may be withheld (Civil Code Sections 8800 and 8802).

### **Closing Out the Claims Exposures—Making Final Payments in Exchange for the Proper Documents**

An owner suspending or terminating a project should not make final payment until and unless the contractor supplies all documentation necessary to eliminate exposure to claims of the contractor and those it hired to do the work. Unlike other areas of real property law, the lack of contractual privity is no obstacle for many construction claims. In addition to the rights of the contractor, many state laws confer mechanic's lien and stop notice rights on a number of parties who directly contribute to the improvement of another's property, whether as contractor, subcontractor, supplier to a contractor or subcontractor, design professional or other services provider. An owner who fails to cut off exposure to these rights risks paying once to the contractor and then a second time to these other claimants.

The owner should have a good sense of which additional parties may be able to assert claims. In California, for example, any lien or stop notice claimant (except prime contractors, union trust funds and persons performing labor for wages) must provide the owner, the prime contractor and the construction lender (if any) with a "preliminary 20-day notice" (Civil Code Sections 8200-8216). A proof of service affidavit for this notice also is required (Civil Code Section 8118). This notice is to be provided not later than 20 days after labor, service, equipment or materials are furnished by the claimant to the project (Civil Code Section 8204). If untimely, that claimant's lien and stop notice rights would only cover items furnished within 20 days prior to service of the notice and any time thereafter (Civil Code Section 8204). By keeping track of the preliminary notices it receives, the owner knows which parties' releases are needed for final payment.

A claimant that has preserved its lien rights by delivering its preliminary notice generally may file a claim of lien in the county land records within 90 days after completion of the project (Civil Code Sections 8410, 8412, and 8414). The date of "completion" is not precisely defined in the statutes (Civil Code Section 8180), so the owner should consider filing a "notice of completion" (Civil Code Sections 8182, 8184, and 8190) or a "notice of cessation" (Civil Code Sections 8188 and 8190) in the county land records and mailing copies of that notice to those parties who filed preliminary notices (Civil Code Sections 8052, 8106, 8108, 8110, 8116, 8118 and 8190). A further benefit of recording a valid notice of completion or cessation is that claimants other than the prime contractor will have only 30 days after recordation, instead of 90 days after completion, in which to file lien claims (Civil Code Section 8414).

As of January 1, 2011, filing a mechanic's lien claim in the California county records will not be sufficient to perfect such a lien. After that date, in order to perfect a mechanic's lien right, a claimant must complete a proof of service affidavit evidencing actual service of the lien claim, along with a notice of the lien, on the owner or reputed owner of the property (amended Civil Code Section 8416). This law also contemplates that a notice of pendency (known as a "lis pendens"), disclosing the existence of a lawsuit to foreclose the mechanic's lien, must be recorded within 110 days after recordation of the mechanic's lien (amended Civil Code Section 8461). The changes in California's mechanic's lien laws were discussed in Pillsbury's Client Alert dated April 3, 2009, entitled "[Contractors and Material Suppliers Gear Up for Possible Changes to California's Mechanics Lien Laws.](#)" To preserve a mechanic's lien right, such a foreclosure lawsuit generally must be filed in the proper court within 90 days after the lien claim is recorded.

Once the potential claimants and actual lien claimants have been identified, the suspending or terminating owner will want to specify the documents that each such claimant must complete before the owner will

release final funds to the contractor. The California legislature has provided a limited set of forms in Civil Code Sections 8132, 8134, 8136, and 8138, including a “Conditional Waiver and Release on Progress Payment Notice,” “Unconditional Waiver and Release on Progress Payment Notice,” “Conditional Waiver and Release on Final Payment Notice” and “Unconditional Waiver and Release on Final Payment Notice.” Close-out documents substantially following these forms are mandatory to evidence a claimant’s waiver and release of its right to further payment from the owner or lender (in the case of the conditional forms, conditioned only on receipt by the claimant of a specified amount).

If a claimant has recorded a mechanic’s lien or stop notice, the owner will want to require that the claimant deliver not only the statutory release form but also a release in a form that the county recorder will accept. (In addition, if a claimant has recorded a lis pendens and filed a lawsuit, the close-out package should include a recordable notice of withdrawal of lis pendens and dismissal of the foreclosure lawsuit with prejudice.) The owner should consult in advance with the recorder’s office in the specific county, since a form accepted in one county may not be recordable in another.

### Final Thoughts

The construction contract and the state statutes are not the only authorities to consult in connection with a suspension or termination of a construction project. The owner should review any applicable disposition and development agreement, loan agreement, lease or other contract that may contain an obligation to complete the work or to notify other parties of the stoppage. Permits, bonds and public improvement agreements with governments may expose the owner to forfeiture of rights or security unless the required actions are taken or the appropriate consents are provided. The owner should consider notifications to sureties, guarantors or others who have provided credit support. A federal bankruptcy filing or threatened filing by any project participant also will affect the analysis of what can and should be done to protect the owner’s position.

Before or concurrently with issuing the suspension or termination notice, the owner should seek control of documents and items that may be difficult to obtain once the contractor is off the job and off the site. Possession of the relevant subcontracts, surety bonds, inspection reports and permits should be confirmed. In some cases, the owner may want to take inventory (or even a video) of the materials that have been delivered or paid for, to ensure that those materials are not disposed of.

No one is happy to stop a construction project that was everyone’s dream when the contracts were signed. However, vigilance by the owner is required to make sure that the troubled job is properly closed out and claims do not become nightmares.

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If you have any questions about the content of this white paper, please contact the Pillsbury attorney with whom you regularly work, or the authors of this alert.

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# Prompt Payment Requirements for California Private Works



| Type of Contract  | Progress Payments   | Final Payment (including retention)  |
|---|---|--|
| <p><b>Owner to Contractor</b><br/>(Civil Code §§8800, 8810-8822, 8830-8848, and 9200, and Business and Professions Code § 7108.5)</p> | <p><b>Basic Rule:</b><br/>Payment within 30 days of receipt of demand of payment in accordance with the contract.</p> <p><b>Exceptions:</b></p> <ul style="list-style-type: none"> <li>• Otherwise agreed to in writing.</li> <li>• Dispute over payment exists — in which case up to 150% of the disputed amount may be withheld.</li> </ul> <p><b>Failure to Pay:</b></p> <ul style="list-style-type: none"> <li>• Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due.</li> <li>• Prevailing party entitled to attorney’s fees and costs.</li> <li>• If contractor is not paid within 35 days from when payment is due (and no dispute exists), owner is at risk of being served a 10-day stop work notice.</li> </ul> | <p><b>Basic Rule:</b><br/>Payment within 45 days after date of “completion.” “Completion” may be issuance of a certificate of occupancy, the date of a notice of completion or notice of cessation or actual completion or cessation.</p> <p><b>Exceptions:</b></p> <ul style="list-style-type: none"> <li>• If portion of the work ultimately will become the property of a public agency, the release of final payment may be conditioned upon acceptance by the public agency.</li> <li>• Dispute over payment exists — in which case up to 150% of the disputed amount may be withheld.</li> </ul> <p><b>Failure to Pay:</b></p> <ul style="list-style-type: none"> <li>• Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due.</li> <li>• Prevailing party entitled to attorney’s fees and costs.</li> </ul> |
| <p><b>Contractor to Subcontractor</b><br/>(Civil Code §§ 8814, 8816, 8818, and Business and Professions Code §7108.5)</p>             | <p><b>Basic Rule:</b><br/>Payment within 10 days of actual receipt of each progress payment.</p> <p><b>Exceptions:</b></p> <ul style="list-style-type: none"> <li>• Otherwise agreed to in writing.</li> <li>• Dispute over payment exists — in which case up to 150% of the disputed amount may be withheld.</li> </ul> <p><b>Failure to Pay:</b></p> <ul style="list-style-type: none"> <li>• Improperly withheld amounts subject to 2% penalty per month.</li> <li>• Prevailing party entitled to attorney’s fees and costs.</li> </ul>  | <p><b>Basic Rule:</b><br/>Payment within 10 days of receipt of all or a portion of the funds by contractor.</p> <p><b>Exceptions:</b></p> <ul style="list-style-type: none"> <li>• If payment received by contractor is designated for a particular subcontractor, then payment must be made to the designated subcontractor.</li> <li>• Dispute over payment exists — in which case 150% of the disputed amount may be withheld.</li> </ul> <p><b>Failure to Pay:</b></p> <ul style="list-style-type: none"> <li>• Improperly withheld amounts subject to 2% penalty per month in lieu of interest otherwise due.</li> <li>• Prevailing party entitled to attorney’s fees and costs.</li> </ul>   |