

ARIZONA PRIVATE SECTOR PROMPT PAY LAW (SB1549)

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Scope of Application: Arizona's Private Sector Prompt Pay Act (SB 1549, 44th Legislature, Second Regular Session 2000) creates new rights and remedies for licensed contractors to require prompt payment of contract receivables in private sector construction projects.

While this new law mirrors existing public sector prompt pay laws in many respects, there are some notable differences in both procedures and time periods. Minor changes were made in existing public sector prompt payment laws concerning choice of venue (the location at which a lawsuit or arbitration of a dispute between the contracting parties must take place) and choice of law. Otherwise, the new prompt payment provisions discussed in this article do not apply to the state of Arizona or political subdivisions of the state.

This law is ambiguous as to whether its new prompt payment remedy applies to Arizona public school districts or charter schools. In other contexts, courts have held that school districts are not "political subdivisions" of the state. Contractors and subcontractors should exercise caution before attempting to apply this law on school projects until the courts have resolved this issue.

It is also unclear whether this new law will provide much benefit to materials suppliers or design professionals. The disclosures of alternative billing or payment terms required by the law may not reach most suppliers. Most of the law's provisions—which are incorporated into the contractors' licensing law—refer specifically to contractors or subcontractors performing work on the project. Materials suppliers should be on guard against efforts to incorporate by reference into purchase orders alternative billing or payment terms found on the project plans. This is another aspect of this new law that is likely to generate some court challenges.

Prohibition of Foreign Venue or Choice of Law: The law declares that any contract term that requires litigation of a dispute involving parties to the project or other dispute resolution procedure (such as mediation, arbitration or other partnering process) outside Arizona is void and against public policy. Likewise, a contract term that makes the law of another state govern the construction contract or its interpretation is declared to be void and contrary to public policy in Arizona. This particular provision of the Act applies to construction in both the private and public sectors because it is incorporated into the procurement laws of Arizona school districts, the Department of Transportation, the Department of Administration (which handles most state building construction), and the "Little Miller Act" that governs almost all other construction by state or local government agencies and improvement districts in Arizona. Contractors working for the Lottery Commission, the Department of Corrections, or the other

designated state agencies that are exempt from the Arizona Procurement Code should determine whether the agency they work for is otherwise covered by the Act before attempting to invoke its protections.

While there are many situations in which courts might refuse to enforce a contract term that seems to apply the law of another jurisdiction to a dispute, or which requires litigation or arbitration of that dispute in a foreign jurisdiction, such decisions are usually based on the unique facts of a particular contract or dispute, and whether the parties actually negotiated this choice of law or venue provision.

Adopting a blanket prohibition of such contract terms is likely to draw a constitutional challenge from a large, out-of-state company that has a policy of requiring such a choice of law or venue clause to standardize its business operations. The courts will have to determine whether this part of the law deprives a foreign firm of equal protection of the law as compared to a domestic Arizona company. Other provisions of the United States Constitution, such as the privileges and immunities clause, may also be employed in an effort to overturn such a restriction on the rights of contracting parties.

Definitions: The parties and contracts subject to this law are defined in the Act. A "construction contract" is a written or oral contract relating to the "construction, alteration, repair, maintenance, moving or demolition of any building, structure, or improvement, or relating to the excavation of or other development or improvement of land." Note that this definition is found only in the portion of the Prompt Pay Law inserted in the contractor's licensing law; it is not repeated in the various amendments to public sector procurement laws. Consequently, if a question arises about whether a particular claimant's contract is covered by this act for public sector projects, it will be necessary to refer to this definition in the contractors licensing law.

An "owner" subject to the law is defined as any type of entity that causes a building, structure or improvement to be constructed, altered, repaired, maintained, moved or demolished, or that causes land to be excavated or otherwise developed or improved. An "owner" for purposes of prompt pay requirements can be a fee owner, a purchaser of property, or a tenant or holder of another interest in the property that is less than a fee ownership.

The term "contractor" is defined as any entity that has a direct contract with the owner of the property to perform work under a construction contract. The term "subcontractor" is an entity that has an agreement with the contractor or another subcontractor to perform a portion of the work required by the construction contract.

Materials suppliers are not referenced in the definitions section of the act, and they do not appear to fall under the classification of subcontractor unless they actually perform work (i.e., installation or construction work) on the project. It is not clear whether materials suppliers will be afforded any of the Act's protections even if they attempt to comply with its terms.



Payment Required Within Seven Days After Approval Of Invoice: The Prompt Pay Act does not change the customary practice for most projects; those that will take more than sixty days to complete usually have a thirty-day cycle for the submission and payment of progress payments or final payments. Consequently, no pre-contract disclosure requirements are necessary if an owner or contractor intends to adhere to the customary thirty-day cycle billing cycle. An owner is obligated to pay the contractor (subject to some exceptions noted below) within seven days after billings or estimates of the work performed and materials supplied during the billing cycle established for the project are "duly certified and approved".

If the owner and contractor on the project are "a single entity" (i.e., an owner/builder), then they must pay subcontractors for their work within fourteen days after the billing or estimate is certified and approved, unless the contract documents have been modified in the manner required by this Act.

A contractor's billing or estimate will be deemed "approved and certified" fourteen days after the owner receives it, unless the owner or its agent provides the contractor with a written statement within that time of those items that are not approved and certified. The law states that the delivery of the billing to the person designated in the contract documents for receipt and review of billings or estimates constitutes receipt by the owner. This condition may cause some confusion and disputes on projects in which the contractor is directed to submit payment applications to the project architect/engineer, a fund control agent, a lender or escrow agent, or a construction manager. Parties responsible for processing contractor payment applications should take care that they are not responsible for unduly delaying processing of payment applications, or they could be held liable for any costs incurred by the owner as a consequence of the delay in making payment.

This processing sequence mirrors the public sector prompt pay statute if the owner and contractor are different entities. In the usual case, the owner should remit payment to the contractor of an approved payment application within twenty-one days after submission of the payment application (fourteen days for approval plus seven days for payment). If the owner and contractor are a "single entity", then subcontractors are entitled to payment within twenty-eight days after submitting their payment applications to the owner/builder (fourteen days for acceptance plus fourteen days for payment). If the contractor does not receive payment within that time, then the interest assessment and rights to suspend or terminate work described below are available to the contractor.

The law identifies a number of grounds that an owner may use to refuse approval of a contractor's payment application, either completely or in part. They are the same grounds listed in the public sector prompt pay law, and are as follows:

- Unsatisfactory job progress
- Defective construction work or materials not remedied
- Disputed work or materials



- Failure to comply with other material provisions of the construction contract
- Third party claims filed or reasonable evidence that a claim will be filed
- Failure of the contractor or a subcontractor to make timely payments for labor, equipment or materials
- Damage to the owner
- Reasonable evidence that the construction contract cannot be completed for the unpaid balance of the contract sum or a reasonable amount of retention

The prompt pay act is unclear about whether this list of objections provides the only acceptable grounds for withholding payment, or whether an owner waives these defenses to payment altogether by not giving notice of an objection within the fourteen-day review period permitted by the statute. These are issues that will have to be determined by the courts when they interpret this new law. Persons responsible for processing payment applications must take care to issue some notice of deficiencies within the allotted fourteen-day period if they wish to preserve that defense for later adjudication of a dispute.

Payment on Final Completion and Acceptance: When a project is finally completed—or any portion of the project for which the contract states a separate price—and the owner has approved and certified all work required under the contract, the owner shall make full payment to the contractor within seven days after this approval. Presumably this section of the law means that phased projects will be paid out in full as each phase or building is completed, and that all retention for the project or completed phase will be released as well. This provision does not mention the customary process for creation of a punch list on the project, and it may conflict with contract terms that would otherwise authorize release of retention pending completion of the punch list work. For example, the AIA contract documents allow a contractor to bill for the release of its retention upon achieving substantial completion of the project, and the owner would be justified in withholding only that amount of the retention or final billing deemed necessary to assure completion of the punch list.

On projects that require a federal agency's final approval or certification of the work, the owner is required to make full payment within seven days after the federal agency issues its approval or certification.

No mention is made of the customary—and usually mandatory—practice for requiring the surety's approval for release of retention on bonded projects. The Prompt Pay Act does not seem to account for this situation.

Notice of Alternate (Extended) Billing and Payment Provision: The Prompt Pay Act obligates any owner who wishes to establish a billing cycle that is different than the customary thirty-day cycle—whether longer or shorter—or payment



terms that are longer than seven days after approval of the invoice to disclose this requirement on each page of any plans prepared for the project. (Sample forms of Notices are reproduced at the end of this article.) The notice of alternate billing cycle (Notice A) or payment provision (Notices B or C) must be conspicuous. The alternate billing cycle must be spelled out in this disclosure or contractors must be given the name and contact information of the owner or owner's agent who can provide this information to them—in writing—on request (Notice B). The time allowed for payment, if it will be longer than seven days after acceptance of the invoice, must also be conspicuously disclosed on every page of the plans for the project (Notices B or C).

Limitations on Withholding of Payments: If an owner believes it is entitled to withhold a portion of a progress payment from the contractor, it may withhold only an amount that is sufficient to pay the direct expenses that the owner reasonably expects to incur in correcting any deficiencies identified in its written notice of deficiencies given to the contractor.

Mutual Consent for Modification of Terms: The Prompt Pay Act allows owners and contractors to mutually change the billing and payment terms after the effective date of the original contract, but any contractor or subcontractor who refuses to agree to such change, in writing, will not be bound by it. This could cause some disputes or mismatched billing cycles between the prime contractor and subcontractors or suppliers, particularly if the suppliers never received notice of, or consented to, an alternate billing or payment cycle in the first place. The law also says that no construction contract may alter the rights of any contractor, subcontractor or material supplier to receive prompt and timely progress payments "as provided under this article". Presumably, this means that no participant in a construction project may attempt to waive or alter the rights of those parties below it in the chain of contracts. The courts will also have to determine what this provision means.

Documentation Required for Payment: Contractors must supply the owner with a billing or estimate of the work performed or material supplied in accordance with the terms of the construction contract between the parties before the time periods and other remedies provided by the Prompt Pay Act will apply.

Interest on Late Payments: If the owner fails to make timely payment to contractor under this Act, the contractor shall be entitled to interest on the unpaid balance at the rate of 1.5% per month (simple interest), or such higher rate specified in the construction contract, until paid.

Notification of Payments to Contractor: Subcontractors at any level of the contracting chain may request (in writing) notification by the owner of any progress or final payment made to the contractor. The owner is obligated to notify any subcontractor making such a written request within five days after issuing a progress or final payment to the contractor.

Recovery of Attorneys Fees and Costs: In any lawsuit or arbitration case brought to recover the payments or interest due a contractor or subcontractor



under this section of the Prompt Pay Act, the successful party shall be awarded a reasonable amount for its costs of suit and attorneys' fees. Presumably the judge or arbitrator deciding the case will make this determination. It is unclear whether the statute will override a contractual term that provides a different method or formula for determining an award of fees and costs, or which waives this right altogether.

Limitation on Subcontractor Retention: Subcontractors are entitled to payment within seven days (fourteen days in case of an owner/builder) after the contractor receives a progress or final payment from the owner of the project. Subcontractors are not entitled to payment as required by the Act until they have submitted a billing or invoice in compliance with the terms of their subcontracts and a conditional mechanic's lien waiver. The contractor may require that subcontractor lien waivers be notarized. If a contractor diverts or fails to account for the application of funds received on account of a subcontractor's work, the subcontractor may file a disciplinary complaint against the contractor with the Arizona Registrar of Contractors. Subcontractors and suppliers may also notify the Registrar—but are not required to do so—if the payment received from a contractor is less than the amount or percentage approved for payment under the terms of this section of the Act.

The contractor is entitled to withhold payment to the subcontractor for any of the grounds listed above for which an owner could withhold payment from the contractor. Written notice to the subcontractor itemizing the grounds for withholding payment, or a portion of the payment, is required within seven days (or fourteen days for subcontractors dealing with an owner/builder) after the subcontractor's payment application is presented to the contractor (or owner/builder).

The contractor may not withhold retention from the subcontractor for any deficiencies identified in that subcontractor's work in an amount greater than that actually withheld by the owner of the project from the contractor. This provision is likely to cause some confusion and disputes because there are situations in which the owner might not assess retention against the contractor but the contractor would still have good cause to withhold payment from the subcontractor. For prime contractors, the safest course of action may be one in which they do not even submit for payment a subcontractor's application for payment—or portions of that application—if they have identified deficiencies or other grounds for withholding payment from the subcontractor. This portion of the Prompt Pay Act may also have other unintended interactions with the Stop Notice Act. Time will tell how contractors and subcontractors will be affected by these unanticipated interactions.

If a contractor fails to pay a subcontractor its progress or final payment in a timely manner as required by the Act, that unpaid balance will accrue interest at the rate of 1.5% per month (simple interest), or such higher rate as the parties agree, from the eighth day after the subcontractor's submittal of its payment application to the contractor. In any action brought by a subcontractor to collect a payment or interest due under the Act, the prevailing party shall be awarded costs and attorneys fees in a



reasonable amount. The warnings noted above with respect to a prime contractor's application for fees and costs also apply in this context.

Right to Suspend or Terminate Performance: If an owner fails to make timely payment as required under the Act, the contractor may suspend its performance of the work or terminate the construction contract, upon giving the owner at least seven calendar days written notice of its intent to do so. This notice period may be shortened by the terms of the owner-contractor agreement. The contractor shall not be deemed in breach of the contract for suspending performance or terminating the contract pursuant to the terms of this Act. A construction contract may not extend the time period for suspension or termination required by the Act.

Likewise, a subcontractor may suspend its performance under a construction contract or terminate its contract if the owner fails to make timely payment of the amounts certified and approved for that subcontractor and the contractor fails to pay the contractor for such certified and approved work. A subcontractor shall provide written notice to the owner and prime contractor at least three calendar days before its intended suspension or termination unless a shorter notice period is prescribed in the subcontract. A subcontractor shall not be deemed in breach of its subcontract for suspending or terminating pursuant to the Act. The subcontract may not extend the time periods for suspension or termination required by the Act.

This provision of the Act may put unintended pressure on prime contractors if, for example, the owner fails to pay for work that has been approved and the contractor is unable or unwilling to advance the payment needed by the subcontractor. The suspension or termination of subcontractor's work on the project for nonpayment may cause immediate disruption and financial loss to the contractor before it impacts the owner financially or affects completion of the project. Consequently, a prime contractor must weigh carefully its options in deciding whether it will also suspend work for nonpayment, or whether it must attempt to persuade the subcontractor to continue working or advance payments to the subcontractor while the contractor attempts to resolve the problems created by the owner's nonpayment.

If the owner pays the contractor but that contractor fails to remit payment of the approved and certified amount due its subcontractor, the subcontractor may suspend its work or terminate its subcontract after giving at least a seven calendar day notice to the contractor and the owner of the project. This notice period may be shortened by the terms of the subcontract, but it may not be extended in the subcontract beyond the time allowed by the Act.

A subcontractor may also suspend its performance or terminate its subcontract if the owner declines to approve and certify for payment portions of the contractor's billing or estimate applicable to that subcontractor's work for reasons that are not the subcontractor's fault or directly related to that subcontractor's work. Once again, a written notice to the owner and contractor of at least seven calendar days is required before this action is taken, unless the subcontract prescribes a shorter time period. The subcontractor shall not be deemed in breach of its subcontract for



exercising its rights under this section of the Act and the subcontract may not extend the time periods prescribed for this notice.

If a contractor or subcontractor suspends performance as provided in this section of the Act, it is not required to furnish further labor, materials, or services until it is paid the amount that was certified and approved for payment, plus any costs incurred for re-mobilization after the shutdown or start-up of the project. It is not clear whether or how this provision applies if the non-payment is due to an owner or contractor's wrongful refusal to certify a subcontractor or contractor's billing for payment. Nor does the Act provide a mechanism for making a speedy determination of remobilization costs in the event the parties do not agree on the amount due. This could give a contractor or subcontractor unfair leverage to use in requiring payment of an unreasonable amount of compensation as a condition to re-starting the project. As with other provisions in the Act, this section also allows for the recovery of a reasonable amount of attorneys' fees and costs by the successful party in any arbitration or litigation.

Any written notice required by this Act shall be deemed given if either of the following occurs:

- The written notice is delivered in person to the individual or a member of the entity or to an officer of the corporation for which it was intended; or
- The written notice is delivered at or sent by any means that provides written, third party verification of delivery to the last business address known to the party giving notice.

Only time will tell whether this statutory notice procedure conflicts with contractual terms that might differ, or whether a party attempting to give notices required by the Prompt Pay Act might abuse this provision by giving that notice to someone other than the person with whom they usually communicate.

Contract Terms Declared Void And Unenforceable: The Prompt Pay Act closes with a declaration of the legislature's statement of public policy concerning contract terms that attempt to undermine the purposes of the Act. Contract terms that make the contractor subject to the laws of another state, or that require any litigation, arbitration or other dispute resolution proceeding arising from the contract to be conducted in another state, are deemed void and unenforceable.

Likewise, any provision, covenant, clause or understanding in, collateral to or affecting a construction contract stating that a party to the contract cannot suspend its performance or terminate the contractor for the other party's failure to make prompt payments as required by the Act is also deemed void and unenforceable.



Effective Date: The Private Sector Prompt Pay Act applies to construction projects if either of the following occurs:

- The owner first distributes plans, specifications or contract documents to any contractor or subcontractor after 18 July 2000;
- or
- The parties sign a construction contract on or after 1 January 2001.

Other Interpretation Issues: In the short period of time that this law has been in effect, questions have arisen about whether the courts in Arizona will give effect to disclosures that satisfy the intent of the prompt pay act without complying literally with the law's requirements. One possible scenario could involve general or supplementary conditions that established special billing or payment terms as a specification applicable to all contractors and subcontractors for that project. Such specifications typically include a term stating that any requirement found in either the specifications or the plans is binding on bidders as though it appeared in both locations. Such a term is intended to assure that contractors bidding on the project are bound by all its requirements regardless of where they appear.

Since no appellate decisions have interpreted this law yet, readers can only rely on general principles of Arizona law to guide their actions. Generally speaking, courts attempt to give effect to all contract requirements to fulfill the parties' intent. The courts also try to apply remedial statutes (i.e., laws that designed to protect some group) liberally so that the intended benefits are realized. Consequently, one would expect the courts to allow some latitude in compliance with the law so long as fair notice was given of any change in billing or payment terms. At the same time, a subcontractor or supplier who did not receive notice of such special terms, due to an owner's failure to disclose those terms on the plans, may be able to avoid the application of those special billing or payment terms to their portion of the work.

Given these uncertainties, readers should take care to inquire whether a project has special billing or payment terms before they bid on new work in the private sector. They should also consult with legal counsel before using the stop work or termination of contract remedies allowed in this new law. In time, the construction industry and design professions should develop routine procedures for complying with this new law, just as they have for the mechanics' lien and stop notice statutes.



Sample Prompt Pay Act Notices

Notice A

Notice of Alternate Billing Cycle

This contract allows the owner to require the submission of billings or estimates in billing cycles other than thirty days. Billings or estimates for this contract shall be submitted as follows: **[Insert terms here.]**

Notice B

Notice of Alternate Billing [Or Payment] Cycle

This contract allows **[may allow]** the owner to require the submission of billings or estimates in billing cycles other than thirty days. **[This contract may allow the owner to make payment on some alternative schedule after certification and approval of billings and estimates.]** A written description of such other billing **[and/or]** cycle applicable to the project is available from the owner or the owner's designated agent at **[insert phone number, address or both]** and the owner or its designated agent shall provide this written description on request.

Special Note: The author has added the bracketed text in sample Notice B above to provide notice of either alternate billing or payment cycles in situations where the A/E does not know the owner's intent. Contact information for the owner or its designated agent is mandatory if Notice B is used. Extreme care should be exercised before using a modified Notice B as contractors may add more contingency to their bid prices if they are uncertain about the length of billing and payment cycles. The A/E should attempt to determine the owner's intent and provide specific information about billing and payment terms whenever possible. These terms could also be incorporated into specifications and invitations for bid.

Notice C

Notice of Extended Payment Provision

This contract allows the owner to make payment within **[number]** days after certification and approval of billings and estimates.



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P. Douglas Folk has represented members of the construction industry and design professions since receiving his law degree with honors from the University of Iowa College of Law in 1980. In addition to his active practice in trials, appeals, administrative proceedings, and alternative dispute resolution procedures, Mr. Folk is involved in many professional and trade associations serving contractors, architects, engineers, and environmental consultants. He was recently re-appointed by Governor Hull to serve on the Arizona Board of Technical Registration, the state agency regulating architects, engineers, landscape architects, geologists, surveyors, and assayers.

Mr. Folk is a past Chairman of the Construction Law Section and a member of the Environmental and Natural Resources Law Section of the State Bar of Arizona. He is also a member of the Federal Communications Bar Association, the Forum on the Construction Industry, the Public Contract Law Section, and the Tort and Insurance Practice Section of the American Bar Association. Mr. Folk has written many articles for publication on construction law and risk management issues. He is also a contributor to the forthcoming *Practical Guide to Construction Law*, which will be published by the State Bar of Arizona.

He has presented a number of educational programs on construction and design issues, risk management and defense of professional liability claims, OSHA compliance, and employment law for AIA Arizona, the Arizona Builders Alliance, Arizona Consulting Engineers Association, Arizona Contractors Association, Arizona Employers Council, Inc.; Associated General Contractors of America, the Arizona Safety Engineers Association, and National Business Institute. He also developed the *Design Professionals Survival Course*[™] and *Contractors Survival Course*[™]; specialized training programs that help contractors and design professionals improve their business practices and avoid or minimize the risk of claims and litigation.

Folk & Associates, P. C. represents general contractors, subcontractors, suppliers, design professionals, and environmental consultants in the mediation, arbitration and litigation of construction law disputes, environmental law issues, and state and federal government contracting issues. The firm also handles commercial and real estate transactions, and it resolves other complex commercial litigation, administrative law, or employment law matters for business owners and managers in many industries.

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