FEDERAL

CONTRACTING

PAYMENT ISSUES

- An Overview

INTRODUCTION

Federal government contracting contains specific statutory rules regarding the payment of contractors. For federal public construction, the Prompt Payment Act and the Miller Act govern not only who, when and how much a contractor will be paid, but also cover restrictions on bringing suit for non-payment. In general, the Prompt Payment Act regulates the construction project payment schedules and methods. The Miller Act supplements the Prompt Payment Act by regulating the surety bonds issued on government work and the method of instituting claims for non payment.

The following is a brief outline of the Payment Issues section.

A. Payment Clauses: required clauses of the Prompt Payment Act.

B. Prompt Payment Act

1. Procedures

2. Who is covered

C. Miller Act Bonds

1. Who is covered

a. First Tier Claimants

b. Second Tier Claimants

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2. What is covered?

PAYMENT ISSUES

A. PAYMENT CLAUSES

Every construction contract awarded by the federal government must include a clause that requires the prime contractor to include in each subcontract the following provisions:

1. *a payment clause obligating the prime contractor to pay the subcontractor for satisfactory performance within seven days after the prime contractor is paid by the contracting agency; and*
2. *an interest penalty clause that requires the prime contractor to pay the subcontractor an interest penalty for payments not made within ten days of payment to the prime contractor by the contracting agency.*[1]
3. *The construction contract between the prime contractor and a subcontractor must also include a provision requiring the subcontractor to include a payment and interest penalty clause in each of its subcontracts.*[2]

It should be noted that certain traditional contract provisions are expressly allowed by statute, even though these provisions may seem contrary to some other provisions required under the statutes. The

[1] Prompt Payment Act, 31 USCS § 3905(b)(1-2).
[2] 31 USCS § 3905(c)

clauses that have been expressly allowed are those which permit the contractor to retain a specified percentage of each progress payment due to a subcontractor without incurring interest penalties, and clauses which allow a contractor to determine that part or all of a subcontractor's request for payment be withheld without penalty if the contractor gives notice to the subcontractor and the contracting agency.

B. PROMPT PAYMENT ACT.

In general, the Prompt Payment Act requires federal agencies to pay their bills on time, to pay interest penalties when payments are made late, and to take discounts only when payments are made within the discount period. Payment is usually deemed to be made on the date a check for the payment is dated. Generally, that payment is required to be made either on the date payment is due under the contract or thirty days after a proper invoice is received by the governmental agency.[3]

The rules for payment and accrual of interest on those payments are slightly different with regard to a construction contract. Like other contracts, payment on construction contracts are governed by the contract between the government and the contractor. Interest penalties are computed at the rate of interest established by the Secretary of the Treasury, and are published in the Federal Registry.

1. Procedures

Certain procedures must be followed in order for a contractor to receive payment. The Prompt Payment Act requires that, in order for payment requests to be approved by a contracting agency, the following qualifying factors be met[4]:

[3] 31 USCS § 3903(a)(1) (2000).
[4] 31 USCS § 3903(b)(1-2)

1. *substantiation of the amounts requested;*

2. *the contractor must submit a certification stating the following:*

    a. *that the amounts requested are for performance of the specifications, terms and conditions of the contract;*

    b. *that payments to the subcontractors and suppliers have been made from previous payments already received under the contract;*

    c. *that timely payments will be made to the subcontractors under their individual agreements; and*

    d. *the application for payment does not include amounts the contractor intends to withhold from a subcontractor*.

If any of the above requirements are not met, the payment will not be processed. Instead, the contracting agency is required to return the defective payment request to the contractor within seven days after the agency has received it complete with a statement explaining why the request was defective.[5]

If the payment request is not returned, the date on which interest begins accruing for late payments is thirty days after the agency received the payment request. A contractor is not entitled to interest for the period of delay in receiving the government's payment where

[5] 31 USCS § 3903(b)(2).

the government complies with the Prompt Payment Act by issuing a check within thirty days after receipt of the contractor's payment request, but a delay occurs that is beyond the government's control. Additionally, interest is payable only when there is a separate underlying claim and an invoice alone does not constitute a claim to which a demand for interest could be attached.

If a contractor unwittingly makes a payment request to the contracting agency, and part or all of the request is for performance that has either not yet been rendered or is for performance that does not perform to the terms of the underlying contract, the contractor must notify the agency of the mistake and give the money back to the government plus interest, calculated from the date of the receipt of the money until the date the contractor notifies the contracting agency of the discrepancy or until the date a subsequent payment request is reduced in order to compensate for the previous overpayment.[6]

3. Who is covered?

The Prompt Payment Act covers not only payment to the prime contractor by the government, but also covers payment to subcontractors by a prime contractor. Prime contractors are required to pay their subcontractors upon each progress payment for substantially completed items. However, a prime contractor can withhold such

[6] 31 USCS § 3905(a).

payment upon written notice to both the contracting agency and the subcontractor. A written notice must include the amount to be withheld, the specific causes for the withholding and the actions that the subcontractor must make in order to receive the payment.[7]

A prime contractor can only withhold money from a subcontractor for reasons related to the underlying contract. For example, if the subcontractor incorrectly installed underpinnings for a staircase, that would be grounds to withhold the amount of the progress payment related to the staircase. However, if the staircase is not completed at the time of the payment, but the subcontractor was only responsible for the underpinnings, if the underpinnings are correctly installed, the subcontractor is entitled to payment.

A notice for withholding of payment to the subcontractor must be given prior to the due date for payment to the subcontractor. If the prime contractor has already received the money from the contracting agency, payment must be made within seven days after the problem is corrected or a late payment interest penalty must be paid to the subcontractor. Additionally, a contractor that withholds payment from a contractor after it has been paid by the government, is obligated to

[7] 31 USCS § 3905(e) and (g)

pay the government any interest accrued on the money until the subcontractor is paid.[8]

[8] 31 USCS § 3905(e)(2-5) and (f).

C. MILLER ACT BONDS

1. Who is covered?

The Miller Act provides that a payment bond obtained by a prime contractor is for the protection of all persons supplying labor and materials in the prosecution of the work provided for in the prime contract.[9] Miller Act protection, however, only extends to the first tier claimants that furnish labor or material under an expressed or implied contract with the prime contractor and to second tier claimants that have a contract with a first tier claimant. Claimants that are neither first nor second tier claimants are not protected by a Miller Act bond.

a. First Tier Claimants

Subcontractors, materialmen, and laborers who have express or implied contractual relationships with a prime contractor are protected under the Miller Act. These claimants have the right to bring suit on a payment bond issued under the Act.[10]

Those who deal directly with the prime contractor under an express or implied contractual relationship are not required to give notice prior to making a claim or filing suit against a Miller Act bond.[11] In order for a claimant to have a direct contractual relationship with either a prime contractor or a subcontractor, the prime contractor or

[9] 40 USCS § 270a(A)(2) (2000).
[10] United States ex rel. Newport News Shipbuilding and Dry Dock Co. v. Blount Bros. Construction Company, 168 F. Supp, 407, 408-09 (D. Md. 1958).
[11] United States ex rel. Munroe-Langstroth, Inc. v. Praught, 270 F. 2d 235, 238 (1st Cir. 1959).

subcontractor must in some way assume responsibility to the claimant to pay for the labor or materials provided upon which the claim is based.[12]

b. Second Tier Claimants

Second tier claimants have no express or implied contractual relationship with the prime contractor furnishing the Miller Act Bond, but do have a direct contractual relationship with a subcontractor. This tier of claimants, along with the first tier, have the right to make a claim or bring suit against the payment bond. However, second tier claimants have the obligation to give written notice of a claim or suit to the prime contractor within ninety days from the last day on which labor was performed or materials supplied to the job site.[13]

Note that the Miller Act does not define the word "subcontractor." The particular facts and circumstances of the disputed situation is required to determine if a party is a subcontractor. A clear prerequisite, however, for qualifying as a subcontractor is the existence of a contract with the prime contractor.[14] Usually, a court will determine the status of a party by looking at the contractual structure of the project as well as the different functions of the different parties in

[12] United States es r. Metal MFG. V. Federal Ins. Co., 656 F. Supp. 1194, 1197 (D. Ariz. 1987)
[13] 40 USCS § 270b(a).
[14] J.W. Bateson Co. v. United States ex rel. Calvin Tomkins Co., 434 U.S. 586, 590 (1978).

the project.[15] These two tests help courts to decide whether a party qualifies as a subcontractor.

To establish the function part of the test, a party must perform for and take from the prime contractor a specific part of the labor or materials required under the prime contract.[16] In determining this, certain factors are usually utilized by the courts. One of these factors concerns the type of labor or materials provided by the alleged subcontractor. Where a party furnishes materials that typically are not custom items but are part of the stock or inventory of a company, that party generally will not qualify as a subcontractor but will be considered a supplier or materialman.[17] However, even if the material provided is of the common variety, if that material is an integral part of the prime contract, the party providing the materials will be classified as a subcontractor.[18]

Another factor considered by the courts in determining subcontractor status under the Miller Act is whether a party actually performs work on the site of the project or merely delivers materials or other items to the job site. Other factors include review of the amount

[15] United States ex rel. K & M Corp. v. A & M Gregos, Inc., 607 F. 2d 44 (3d Cir. 1979).
[16] Clifford F. MacEvoy Co. v. United States ex. Rel. Calvin Tomkins Co., 322 U.S. 102, 108 (1944). See also J.W. Beteson Co. v. United States ex re. Board of Trustess, 434 U.S. 586, 590 (1978).
[17] United States ex rel. Conveyor Rental & Sales Company v. Aetna Casualty & Surety Co., 981 F. 2d 448 (9th Cir. 1992).
[18] Basich Bros. Construction Co. v. United States ex rel. Turner, 159 F. 2d 182 (9th Cir. 1946).

of the "subcontract" in relation to the "prime contract"[19], the procurement of a performance bond by the aspiring subcontractor to cover the performance of work under its subcontract,[20] and the receipt of progress payments by the subcontractor.[21]

c. Third Tier and Other Claimants

Any claimant more remote than a second tier claimant is not entitled to recover under the Miller Bond Act.[22]

2. What is covered?

a. Labor

The Miller Act provides coverage for labor and material used in the prosecution of work on a federal project.[23] If a bond principal defaults and does not pay for wages accrued by his workmen, the Miller Act Bond will cover the wages that are due and owing. Union contributions, contributions to employee funds, health and welfare funds are usually recoverable on the basis that such payments are required under the employee contract or agreement.[24]

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[19] Miller Equipment Co. v. Colonial Steel & Iron Co., 383 F 2d 699 (4th Cir. 1967).
[20] Aetna Casualty and Surety Co. v. United States ex re. Gibson Steel Co., 382 F. 2d 615 (5th Cir. 1967).
[21] United States ex rel. Wellman Engineering Co. v. MSI Corp., 350 F. 2d 285 (2d Cir. 1965).
[22] United States ex rel. Powers Regulator Co. v. Hargord Accident and Indemnification Co., 376 F. 2d 811 (1st Cir. 1967).
[23] 40 USCS § 270a(a)(2).
[24] J.W.D., Inc. v. Federal Insurance Company., 806 S.W. 2d 327, 329 (Tex. App. 1991).

A surety providing a Miller Act Bond is also liable for withholding taxes.[25] Specific notice by the government to the surety, however, is required before a surety need pay for the withholding taxes.

b. Materials and Equipment

Materials that are covered are those that are furnished with the reasonable expectation that they will be substantially consumed or used on the project.[26] Additionally, when a claimant, in good faith, believes that the material is intended for the project, even if those materials are diverted to a use outside the project, the claimant is entitled to recovery. This is true even if the materials are not delivered to the job site.[27]

When a claim for equipment is asserted, if that claim is for recovery of the purchase price of the equipment, the Miller Act will usually not allow recovery under the bond. Courts will generally look at the purchase price of the equipment as compared to whether the equipment was substantially consumed during the project.[28] On the other hand, claims for unpaid rental charges for equipment as well as maintenance and repair fees are usually covered by the bond.

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[25] 40 USCS § 270(a)(d); United States v. Fidelity & Deposit Company of Maryland, 690 F. Supp. 905 (D. Hawaii 1988).
[26] United States ex rel. Krupp Steel Products, Inc. v. Aetna Insurance Co., 831 F. 2d 978, 980 (11th Cir. 1987).
[27] United States ex rel. Carlson v. Continental Casualty Co., 4143 F. 2d 431, 433 (5th Cir. 1969).
[28] United States ex rel. Balzer Pacific Equipment Co. v. Fidelity & Deposit Co. of Maryland, 894 F. 2d 546, 550 (9th Cir. 1990).

D. MILLER ACT TIME LIMITATIONS AND PROCEDURES

Though there is usually no requirement that notice be given by First Tier claimants, other claimants must always give written notice in order to assert claims. Failure to provide notice within the specified time will result in abandonment of the claim. Under the Miller Act, giving written notice has been held to be a jurisdictional prerequisite to recovery; it cannot be waived. An unusual aspect is that it may even be raised for the first time on appeal.[29] Those who do not have a direct contractual relationship with the prime contractor must give notice.[30] The notice must be given directly to the prime contractor.[31]

When a prime contractor is served with notice, it essentially alerts the prime contractor that the claimant is seeking contribution directly from the prime contractor. The notice requirement for lower tier claimants, therefore, serves an important purpose. Usually the lower tier claimants are paid not by the prime contractor, but by the prime contractor's subcontractors. So even if a prime contractor has already paid the subcontractor in full for the work or material for which the claim is being made, it, along with its surety, can be held liable on the payment bond to a materialman or sub-subcontractor who has not been paid by said subcontractor. The notice requirement, therefore,

[29] Aetna Casualty and Surety Co. v. Doleac Electric Co., Inc.., 471 So. 2d 325 (Miss. 1985).
[30] 40 USCS 270b(a).
[31] United States ex rel. Keener Gravel Co., Inc. v. Thacker Construction Co., 478 F. Supp. 299 (D. Mo. 1979).

enables a prime contractor to avoid double liability by fixing a date beyond which, absent notice, it will no longer be liable for its subcontractor's debts.

As a result, most prime contractors withhold payments to their subcontractors until after the expiration of the notice period. Other methods used by prime contractors to shield themselves from the double liability include paying subcontractors with checks issued jointly to the subcontractor and its suppliers or requiring performance or payment bonds from its subcontractors. Another, less used option, is paying the sub-contractors directly. However, paying sub-contractors directly could establish a first tier claimant out of a second tier claimant, and may not be a prudent gesture.

1. Notice Formalities

The notice must be in writing. The Miller Act requires that the notice be sent by registered or certified mail.[32] The notice must show an intent to assert a claim, and it must state the amount of the claim. The name of the person for whom the work was done or to whom the material was supplied must also be included.

2. Time Limitations

The Miller Act requires that the notice of claim must be served within ninety days of the last date upon which the claimant furnished

[32] 40 USCS 270b(a).

labor or material for which the claim is made.[33] It should be noted that the federal courts are split as to whether notice can be given before the last day on which the claimant furnished materials or labor on the project.[34]

A suit based on a notice of claim must be commenced within one year after the day on which the last of the labor was performed or material was supplied by the claimant.[35] This provision may not be waived.[36] Additionally, suit may not be commenced before the end of the first ninety days after the labor was performed. Such a lawsuit will be dismissed and will have to be refilled after the end of the ninety day period.[37]

3. Procedural Requirements

Suits pursuant to the Miller Act must be brought in the United States District Court for the district in which the contract was to be performed.[38] The United States Federal Courts have exclusive jurisdiction over the Miller Act. As a result, suits brought in state courts must be removed to the corresponding Federal District Court. Note that the wording of the act also restricts the venue with regard to which District Court in which a suit may be instituted. A claimant may

[33] 40 USCS 270b(a).
[34] The Fourth, Sixth, and Tenth Circuits allow notice to be given before the last day on which materials or labor are provided to the project; the Third, Fifth an Ninth Circuits do not allow such notice.
[35] 40 USCS 270b(b).
[36] Chicago Rigging Co. v. Uniroyal Chemical Co., Inc., 718 F. Supp. 696 (N.D. Ill. 1989).
[37] 40 USCS 270b(a).
[38] 40 USCS 270b(b).

bring suit only in the district in which the contract was to be performed, unless waived by the parties. Forum selection clauses in subcontracts are enforceable according to the usual rules governing them. Suits brought in the wrong District Court will either be removed to the correct venue or dismissed by the court.[39]

With regard to arbitration and arbitration awards, certain problems arise with regard to the Miller Act. Since Federal Courts have exclusive jurisdiction over Miller Act claims, forcing a surety into arbitration is not allowable. Federal courts are very reluctant to require sureties to arbitrate, even when the contract between the contractors contains an arbitration clause. Usually, the arbitration clause must be contained in the surety agreement.[40]

[39] 28 USCS 1406(a).
[40] United States ex rel. Capital Electric Construction Co., Inc. v. Pool and Canfield, Inc.,788 F. Supp. 1088 (W.D. Mo. 1991); United States Fid. & Guarantee Co. v. West Point Construction Co., 837 F. 2d 1506, 1508 (11th Cir. 1988).