

Getting Paid When A Project Stalls Before Construction Begins

By Robert M. Osier, R.A., Esq.

With the increasing use of design/build as the project delivery system, the contractor is taking on greater financial risk for project's upfront costs of design and other preconstruction services. The risk will quickly turn into a liability if the project stalls before construction begins due to factors not within the control of the contractor, such as lack of project funding. The first line of protection to ensure payment for upfront costs is through the parties' contract. But other traditional methods of ensuring payment of these fees, such as recording a mechanic's lien or serving a stop notice, may not be available to the contractor as demonstrated in the recent decision in *D'Orsay International Partners v. Superior Court (Jeffrey Stone, Inc.)*, 123 Cal. App. 4th 836 (Cal. App. 2d Dist. 2004).

In the D'Orsay case, the contractor, Jeffrey Stone doing business as Summit Builders, performed \$850,000 worth of preconstruction services, including contracting for design services, for a hotel project that defendant owner, D'Orsay International Partners, planned to build in Long Beach, California. Prior to the issuance of a building permit or the commencement of any construction work, D'Orsay terminated that project because it was unable to secure project financing. Mr. Stone recorded a mechanic's lien against D'Orsay's real property in Long Beach. Soon thereafter, Mr. Stone sued D'Orsay for breach of contract and other causes of action, including foreclosure on the mechanic's lien, to recover the \$850,000 in unpaid preconstruction services. Early in the case, D'Orsay requested that the court issue an order releasing the mechanic's lien on the basis that Mr. Stone could not record a lien because no construction had begun on the property. The trial court refused to grant the order. D'Orsay then appealed the trial court's ruling on this issue to the Court of Appeal.

The appellate court reversed the trial court's ruling and directed the trial court to order the release of Mr. Stone's mechanic's lien. The appellate court agreed with D'Orsay's argument that because no work had been performed at the site, there was no improvement to the property to which a lien could attach. The appellate court explained that it is essential to the recording of a mechanic's lien that some work has commenced on the property, even if that work is as little - as some courts have held - as the delivery of materials to the project site. The appellate court also rejected Mr. Stone's claim that his mechanic's lien was akin to a design professional's lien that can be recorded before construction begins and is expressly for the purpose of recovering payment of the design professional's fees should the project not go forward. The court made clear that the lien at issue was a mechanic's lien, not a design professional's lien, and therefore the rules for mechanic's liens applied.

By basing its decision on the well-settled principles underpinning mechanic's lien law, the D'Orsay court did not rule on whether a "contractor" providing design services may record a design professional's lien as added protection for recovery of payment of preconstruction services should the project not go forward as planned. But it did suggest that a contractor would likely not be entitled to do so because "contractor" does not fit within the narrowly statutory definition of a design professional as a "certificated architect, professional engineer, or licensed land surveyor who furnishes services pursuant to a written contract with the landowner...." (See, California Civil Code, §3081.1.)

How then is a contractor to ensure that it will recover payment for preconstruction services when the project ends before the start of construction? As noted above, the primary protection is to negotiate an appropriate clause in the contract with the owner. But this approach would not prevent suits against the contractor by its subcontractors and design professionals seeking recovery of payment for their preconstruction services while the contractor is pursuing its remedy against the owner.

One way to keep the focus on the ultimate party responsible for payment - the owner - is for the contractor to include in each of its subcontracts, including agreements with design professionals, a flow

down clause that incorporates the disputes procedures of the prime contract for claims arising from the owner's non-payment. The contractor should also require in its agreements with design professionals that they record design professional's liens whenever appropriate. Additionally, the contractor should consider requiring the assignment of the designer's right to foreclose on its design professional's lien should the owner fail to pay for the design services, and that any action by the design professional to collect payment from the contractor must be stayed until the completion of the foreclosure action against the owner.

As for its subcontractors, arguably the contractor could include a "pay if paid" clause for preconstruction services (only) that would pass the risk of the owner's failure to pay to the subcontractor. Although the California Supreme Court in *William R. Clarke Corp. v. Safeco Insur. Co.*, 15 Cal. 4th 882 (1997) ruled "pay if paid" clauses in subcontracts for private projects are unenforceable as an "impermissible indirect waiver or forfeiture of the subcontractor's constitutionally protected mechanic's lien rights in the event of nonpayment by the owner," this rule would not apply during the preconstruction period. As confirmed by the D'Orsay court, contractors (and subcontractors) do not have any mechanic's lien rights prior to the commencement of construction. Accordingly, a contractor seemingly could include a "pay if paid" clause for preconstruction services without being at odds with the *Clarke v. Safeco* decision. The same would not be true for design professionals, however, because, as noted above, they do have lien rights for their preconstruction services.

In addition to carefully drafted and integrated contracts with the owner, subcontractors and design professionals, there are other methods a contractor could employ to ensure payment of its preconstruction services if the owner terminates the project before construction begins. For example, the prime contract could require that the owner secure a specially prepared payment bond to pay for preconstruction services in the event the project stalls and the owner refuses or cannot pay the contractor. Another protection would be to establish a special escrow account for the owner's advance of the estimated amount of the preconstruction fees together with special instructions for disbursement of these funds should the project terminate before construction.

In light of the D'Orsay decision and the increasing frequency of con-

tractors performing preconstruction services, a contractor must be proactive in mitigating a risk of nonrecovery of fees and costs incurred in the event the project stalls before any construction begins.

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