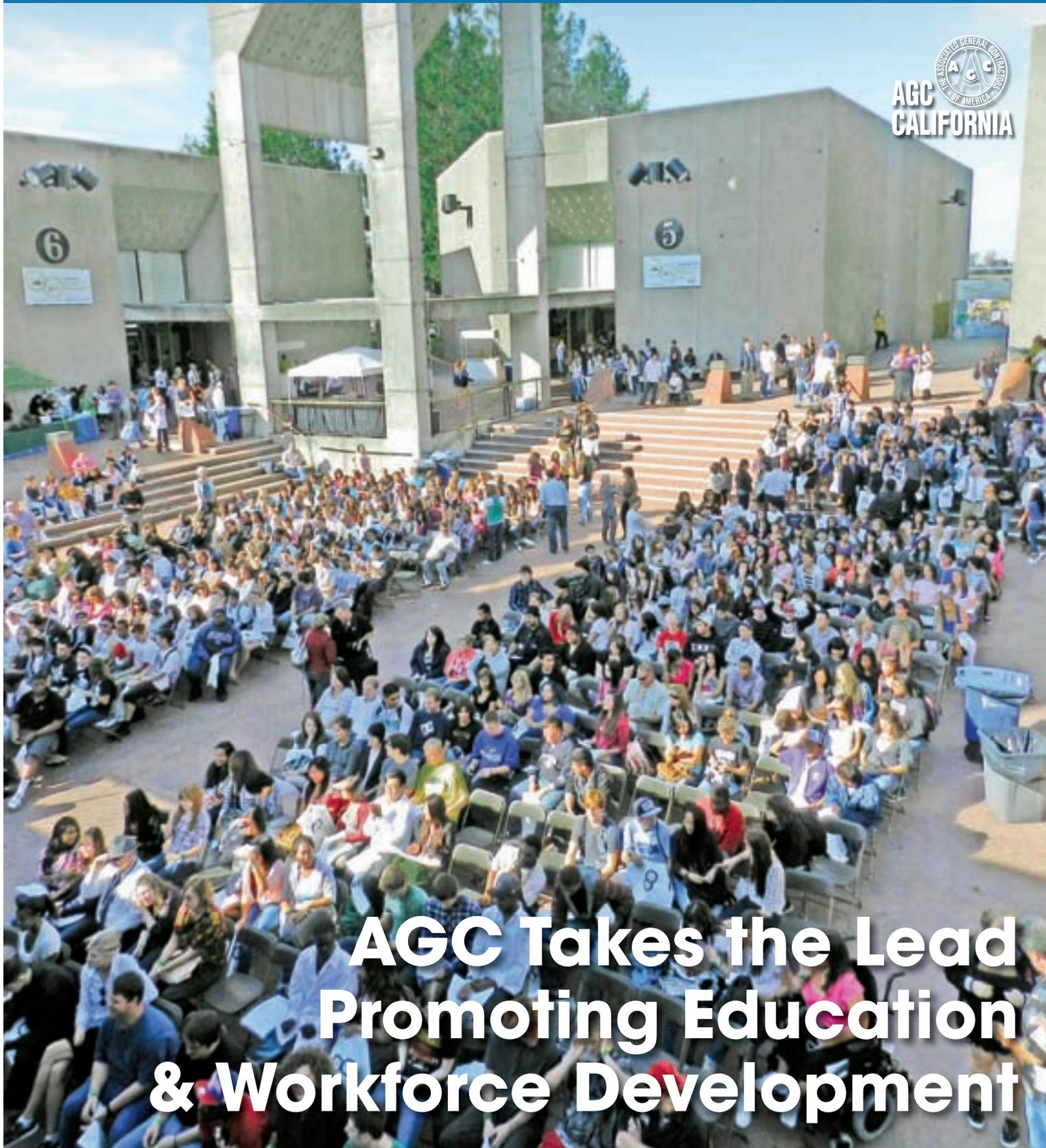


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# Understanding the Hidden Traps in Payment to Subs on Federal Projects

By Bob O'Connor and Andre Campbell



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In “The Wizard of Oz,” Dorothy was taken from a familiar world to one where everything operated by different rules, and hidden threats lurked in seemingly normal surroundings. The same thing can

happen to contractors who work on federal projects.

Although most California contractors have a good general understanding of the rules governing payments by prime contractors to subcontractors on state and

local agency projects in California, the rules applicable to federal projects are less well understood. They also differ in many ways from the rules which apply to state and local agency projects, and the risks of non-compliance are substantial. While an exhaustive discussion of payment issues on federal contracts is beyond the scope of this article, we would like to highlight several payment issues that are “traps for the unwary.”

For purposes of this article, “federal projects” are projects where the owner entering into the prime contract is the United States government. The payment rules applicable to federal projects are found in a combination of federal statutes and the Federal Acquisition Regulation (“FAR”) and its supple-



Andre Campbell

ments. Typically, the relevant FAR clauses are incorporated by reference into the contract documents. The contract clauses referred to in this article are all located within FAR section 52.232.

## Rules Regarding Retention on Federal Projects

The contracting officer for each project determines whether retention will be withheld from the contractor. Notwithstanding the preceding rule, a contractor on a feder-

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al project may include a standard retention clause in its subcontracts.

This does not mean, however, that the contractor is permitted to bill the government for amounts which will be withheld from a subcontractor pursuant to a standard retention clause. For example, if Subcontractor A has performed \$100,000 worth of work in a given month, the subcontract has a standard 10% retention clause, and the contractor intends to withhold retention from the subcontractor in connection with the payment, then the contractor may bill the government for only \$90,000 in connection with Subcontractor A's work.

### Progress Payments to Subcontractors on Federal Projects

On federal projects, the contractor must pay its subcontractors "not later than seven days from receipt of payment out of such amounts as are paid to the contractor ...". If payment is not made within seven days, the contractor will be liable to the subcontractor for an interest penalty.

As noted above, the contractor is not permitted to bill the government for any amount that it intends to withhold from a subcontractor. This applies not only to amounts retained under a standard subcontract retention clause, but also to amounts withheld due to back charges or alleged deficiencies in the subcontractor's performance. Reinforcing this rule, the FAR contract payment provisions state that the contractor must include with each payment request a certification that the request for progress payment does not include any amounts which the contractor intends to retain or withhold from a subcontractor or supplier. Obviously, an improper certification could make the contractor liable to the government under the federal False Claims Act.

### The Contractor's Obligation to Notify Subcontractor of Withholding

If a contractor on a federal project decides to withhold all or part of a subcontractor's payment request, the contractor must provide written notice to the subcontractor of the withholding. This written notice must be sent prior to the due date for the subcontractor payment. The written notice must specify: (1) the amount to be withheld, (2) the specific causes for the withholding under the terms of the subcontract, and

(3) the remedial action to be taken by the subcontractor in order to receive payment of the amount withheld. A copy of this notice must be sent to the contracting officer. If the contractor fails to provide written notice of the withholding, the contractor will be liable for late payment penalties.

Similarly, if a contractor on a federal project discovers a cause for withholding from a subcontractor after the contractor has submitted its pay request to the government but before payment has been made to the subcontractor, the contractor must provide written notice to the subcontractor of the withholding. This written notice must be sent prior to the due date for the subcontractor payment, with a copy to the contracting officer, and must specify the three items described above. Again, if the contractor fails to provide written notice of the withholding, it will be liable for late payment penalties.

Within seven days after the subcontractor remedies any cause for withholding, the contractor must make payment to the subcontractor. If the contractor fails to make payment within this time period, it will be liable for late payment penalties. When payment of the withheld amount is made to the subcontractor, the contractor must notify the contracting officer. The notice must state the amount withheld and the dates the withholding began and ended.

### The Contractor's Obligation to Pay Interest to Government on Unearned Amounts

If the contractor receives funds from the government and then decides to withhold payment from a subcontractor, the contractor must pay interest to the government on the withheld payment amount. In the alternative, the contractor may elect to return the withheld amount to the government.

The rules discussed above apply to material supply contracts as well as subcontracts.

### Required Subcontract and Material Supply Contract Clauses on Federal Projects

On federal government projects, the contractor must include the following clauses in each of its subcontracts and material supply contracts: (1) a clause that obligates the contractor to make payment within seven days after the contractor receives payment from the government, (2)

a clause that obligates the contractor to pay an interest penalty on late payments, and (3) a flow-down clause that obligates the subcontractor or material supplier to include the same clauses in its lower-tier subcontracts and material supply contracts.

### Conclusion

Since private construction projects have all but disappeared, and most state and local public entities are suffering budget restrictions that limit their construction projects, federal contracts remain a good source of available construction work. Navigating the maze of federal contracting rules is never easy, but understanding the hidden pitfalls concerning payments to subcontractors on federal construction contracts can get you halfway home. 🛑

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## Coming in the California Constructor

The January / February issue of the *California Constructor* magazine will highlight all of the winners of the 24th Annual Safety Awards of Excellence. The issue will also feature AGC of California's new leadership for 2012.

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- **July/August:** 25th Annual Constructor Awards Issue
- **September/October:** Legislative & Regulatory Issues
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For future editorial contributions or suggestions, please contact editor Carol Eaton at eatonc@comcast.net or (707) 789-9520. 🛑