Subcontracting Is A Risky Business: Ensuring Payment On Public-Private Partnerships?

By Zachary D. Jones
Stites & Harbison, PLLC

Construction projects are like onions — and ogers — they have many layers. On a typical construction project an owner will contract with a general contractor who will then contract with subcontractors, who may themselves contract with even lower tier subcontractors. Ultimately, there tend to be many intermediaries between subcontractors doing the work and owners who benefit by the work on construction projects. One problem that results from this for subcontractors is how they ensure payment for their work if the contractor with whom they have contracted refuses to pay?

One way subcontractors can protect themselves is by encumbering the property in which they invest their labor. To this end, all fifty states have enacted special statutory lien laws referred to as mechanic’s liens. A mechanic’s lien provides subcontractors a means of asserting their rights in the property underlying a construction project. Thus, one way a subcontractor can ensure payment after completing work is by perfecting a mechanic’s lien on the property.

A mechanic’s lien may not always be available. While a subcontractor’s lien against, for example, a home or office building being built by a private developer will attach and may be perfected, a subcontractor’s lien cannot attach to government property. A basic tenant of sovereign immunity is that a private person may not claim against a sovereign, unless that government specifically allows the claim. Accordingly, absent a legislative exception, a subcontractor’s mechanic’s lien will not attach to public property. A subcontractor on a public project is then seemingly left without an expeditious way to recover payment from the prime contractor after completing its work.

Both state and federal law provide subcontractors an alternative on public projects. At the federal level, the Miller Act, 40 U.S.C. §§3131–3134, provides that prime contractors must provide payment bonds for federal projects. A payment bond is a surety-backed guarantee that subcontractors who perform work on the bonded project will receive payment as agreed. If a subcontractor is not paid within 90 days after payment is due, the subcontractor can sue the surety under the Act. Similarly, all fifty states have enacted laws, referred to as “Little Miller Acts,” providing essentially the same payment bond requirement and subcontractor recourse as the Miller Act. Therefore, subcontractors can ensure payment on public projects by suing on the payment bond that prime contractors are required to provide.

It would seem then that subcontractors have a clear roadmap to ensure payment. If the project is private, they can attach and perfect a mechanic’s lien. On the other hand, if the project owner is a public entity, they can simply sue on the payment bond. So where is the problem? The problem lies in the form of project delivery that has become all the rage: Public-Private Partnerships (“P3s”).

P3s are a unique form of project delivery using private money for public purpose. In a traditional public project delivery scheme, if an owner, say State X, wants to build a project on land it owns it simply goes out and pays a contractor to build the project. At the end of the project, the contractor walks away having no interest in the underlying project or property upon which the project was built. If State X, however, utilized a P3 to deliver the project, at the end of construction the contractor may have a continuing interest in either the project, the improved property, or both.

P3s can have many forms. Ultimately, a P3 lies somewhere between total government control over construction, operation, and maintenance of a public asset and privatization of that asset. For example, P3s may be a long-term lease of land on the condition that the contractor build, operate, and maintain a toll road. Or, P3s may take the form of a contract between a private entity and the government to build and operate an asset on land that remains in the hands of the government. The practical import is that projects delivered via P3s blur the line between public and private projects.

Whatever the form of the project delivery scheme, P3s have definable characteristics. P3s necessarily involve a higher level of cooperation between the public and private market participants. This cooperation creates inherently discrete risk allocations when compared to more traditional project delivery schemes. Traditionally, the public owner bares all economic risk after the construction phase is complete. In a P3, however, the public owner is able to offset some economic risk by

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allowing the contractor to share in some economic benefits beyond completion of construction. Therein lies the problem: A subcontractor’s recourse to ensure payment depends on the nature of the holder of the post-construction economic interest. Because P3s do not delineate such post-construction interests on the grounds of whether the holder is public or private in nature, the subcontractors recourse becomes unclear.

Regardless of the form, though, the subcontractor on a P3 project is not dealing with an entirely public or private entity: the subcontractor is dealing with a combination of both. Accordingly, it would appear the doctrine of sovereign immunity prevents the imposition of a mechanic’s lien on the property. At the same time, however, there is a private entity that also has an interest in the property both during and after construction. Therefore, P3s do not fit squarely in either the mechanic’s lien statutes or the Miller/Little Miller Acts. Subcontractors are left guessing how to proceed if they remain unpaid after completing work as agreed on a P3 project.

Fortunately, at least some states’ legislatures and a few courts have looked at the issue and give some guidance for subcontractors to follow. In Oklahoma, for example, subcontractors received clarity from an amendment to that state’s Little Miller Act, Okla. Stat. tit. 61, § 1(A) (2012). There, Oklahoma provided that payment bonds are required on private projects constructed on public lands. While this approach remains the minority, if P3s continue to gain in popularity, such modification to the Little Miller Acts of each state is likely to be included with P3 enabling legislation.

Absent statutory clarification, subcontractors have attempted to utilize mechanic’s liens on P3 projects. The courts that have addressed this issue seem to distinguish whether the mechanic’s lien can attach based on the underlying interest to which attachment is sought. California, which has been at the forefront of the development of P3s, provides a good framework for drawing this distinction. In North Bay Construction, Inc. v. City of Petaluma, 49 Cal. Rptr. 3d 455 (Ct. App. 2006), a subcontractor attempted to attach a mechanics lien to the land underlying a sports complex constructed by a private developer on public land. There, the government leased land to a developer who contracted with a builder to construct a sports complex. After completing its work, the contractor was not paid. The contractor sought to attach a mechanic’s lien to the property. The court held that the contractor’s lien could not attach because the property to which the lien was attempting to attach was public.

Four years later, in South Bay Expressway v. Otay River Constructors, 434 B.R. 589 (Bankr. S.D. Cal. 2010), another court in California considered a similar issue. In South Bay, the state leased to a developer public land for the construction of a toll road to be operated by the private entity for 35 years. After the contractor who built the road was not paid, it attempted to attach a mechanic’s lien to the leasehold, not the underlying property, and subsequently perfect and foreclose the lien. The court held that because the lien was attaching to a private interest, the leasehold and franchise, and not the public land, the contractor’s lien attached and could be foreclosed.

North Bay and South Bay may demonstrate how courts will analyze the applicability of mechanic’s lien laws to P3 projects. The resolution, of course, will depend on each state’s property law. Specifically, whether a mechanic’s lien can attach to a leasehold, without also attaching to the underlying property. Ultimately, because P3s are relatively new in the U.S., subcontractors cannot definitively determine if a mechanic’s lien will be available to help ensure payment on a P3 delivered project.

In the face of such ambiguity, subcontractors would be wise to insist that their prime contractor provide a payment bond. In the real world, of course, that is not always possible. A subcontractor’s need for work may trump their desire to walk away from a potential contract. However, understanding exactly what that means—i.e., that the subcontractor may not be able to rely on a mechanic’s lien if it is not paid—remains important when determining at what price the subcontractor is willing to accept risk of non-payment.

Zachary D. Jones
Stites & Harbison, PLLC
400 West Market Street, Suite 1800
Louisville, Kentucky 40202-3352
zjones@stites.com
www.stites.com
P: 502.681.0439
F: 502.223.4395