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The “pay-if-paid” clause

Know what you’re dealing with

In recent years, increasing numbers of owner bankruptcies and insolvencies have brought pay-if-paid (PIP) clauses into the spotlight. These clauses — which shift the risk of owner nonpayment from general contractors to subcontractors — are controversial.

Some say it’s unfair to require subs to bear this risk because they aren’t in a position to evaluate the owner’s creditworthiness or to protect themselves against owner default. Others assert that the parties to a construction contract should be free to allocate risk as they see fit. So long as the sub understands the significance of a PIP clause, they argue, it can weigh the risk and build a “risk premium” into its price.

Whatever your opinion of PIP clauses, they’re common in construction contracts, so you need to understand their impact.

Say the magic words

A PIP clause provides that the general contractor isn’t obligated to pay the subcontractor unless and until the owner pays the general contractor. In most states, courts enforce PIP clauses if they explicitly provide that receipt of payment from the owner is a condition precedent to the general contractor’s obligation to pay the sub. One reason for this is the view that shifting the risk of nonpayment to a subcontractor is a harsh result that should be imposed only if the language of the contract is clear and unambiguous.

To help ensure that PIP clauses are enforceable, general contractors should use the term “condition precedent” in their contracts. It’s also a good idea to include language to the effect that the subcontractor expressly assumes the risk of nonpayment by the owner.

In some states, the courts allow sureties to assert a pay-if-paid clause as a defense against a subcontractor claim.

Be aware, however, that even properly drafted PIP clauses may be unenforceable. In some states, such as New York and California, courts have held that PIP clauses violate public policy by forcing subs to waive their statutory mechanics’ lien rights. In others, state legislatures have passed laws banning or limiting the use of PIP provisions.

Even in states where PIP clauses are enforceable, they can be invalidated if the general contractor improperly causes the owner to withhold payment (for example, by breaching its contract with the owner).

Impact on surety bonds

If an enforceable PIP clause prevents a subcontractor from collecting from the general contractor, can the sub still make a claim against the general contractor’s payment bond? Here, again, the outcome varies from state to state.

In some states, the courts allow sureties to assert a PIP clause as a defense against a subcontractor claim. These courts follow the general rule that a surety “stands in the shoes” of the general contractor and may avail itself of the general contractor’s contractual defenses.

In other states, the courts have held that extending the protection of a PIP clause to a surety would defeat the purpose of a payment bond, which is to ensure payment of subs and suppliers in the event the general contractor doesn't pay.

Protect yourself

If you're a general contractor and wish to secure the protection of a PIP clause, review the applicable law for each state in which you do business. For contracts governed by states that permit PIP clauses, make sure the clauses are drafted carefully to make your intentions crystal clear.

If you're a subcontractor being asked to sign a contract that contains a PIP clause, understand and evaluate the risks involved, and then price your services accordingly. Also, consider including similar provisions in your contracts with sub-subcontractors and suppliers, so you're not obligated to pay them unless and until the general contractor pays you.

Whether you're a general contractor or a sub, because laws regarding the enforceability of PIP clauses vary from state to state, it's important to be familiar with the law in the states in which you work and have your lawyers review these provisions carefully. ■

Pay-if-paid vs. pay-when-paid

In terms of language, the difference between a pay-if-paid (PIP) clause and the related pay-when-paid (PWP) clause is a subtle one, and the terms are often used interchangeably. While a PIP clause says that the general contractor must pay a subcontractor *only if* it receives payment from the owner, a PWP clause provides that the general contractor must pay the sub within a specified time (seven days, for example) after receiving payment from the owner.

Arguably, the impact of these two provisions is the same: If the owner never pays, then the general contractor's obligation to pay the subcontractor never arises, whether the contract contains a PIP clause or a PWP clause. But most courts treat PWP provisions as governing only the *timing* of payment. Even if the owner fails to pay, the general contractor remains obligated to pay the sub within a "reasonable time."

Looking for a new revenue source?

Consider consulting on cost segregation studies

A cost segregation study, which involves identifying the specific assets that make up a building and their costs, can provide benefits to both building owners and to your contracting company. The owner reaps the rewards of considerable tax deferral and you, the contractor, can consult on this much-needed service and thus open up a new profit center.

How it works

A cost segregation study typically separates "real," or structural, property from "personal" property, such as decorative fixtures. Once the personal property is identified, it's analyzed and then classified for federal tax purposes.

The process of classification includes assigning the assets acceptable depreciable "lives," based on the Internal Revenue Code, IRS guidance and case law. Then a report is typically issued outlining the new classifications.

Real property is usually depreciated over 39 years (27.5 years for residential real estate). But a cost segregation study allocates portions

Typical items eligible for cost segregation

Here's a partial list of items that qualify for faster write-offs:

- Primary and secondary electrical distribution systems conveying power to electrical, plumbing or HVAC equipment and to internal communications mechanisms, such as computers and telephone lines,
- Security equipment,
- Carpeting, vinyl floor coverings, accordion doors and partitions,
- Signs, as well as decorative and security lights, and
- Cabinets, decorative millwork and removable vinyl wall coverings.

of the purchase to shorter lives, which allows the owner to depreciate those segregated assets over five, seven and 15 years.

Thus, the major benefit of a cost segregation study is a significant deferral of taxes and a resulting increase in cash flow for the building's owner in years following the study. How, you might ask? Depreciation deductions are accelerated into earlier years, thus reducing income tax liability for those years.

Cost segregation isn't a risky or aggressive tax scheme. Court rulings dating back to the 1960s support the practice of segregating costs, and in 1997 the U.S. Tax Court ruled that the practice of segregating building costs for tax purposes was allowable.

Show me the money

As you might suspect, cost segregation studies are typically headed up by a CPA. But many look to construction companies to help them gather the relevant information and then develop the study. The contractor receives a consulting fee for his or her services.

You can likely aid in many functions of the process, but perhaps the most significant is that you can help determine the costs associated with qualifying assets, potentially in one of two ways:

1. If the building is new construction performed by your construction company, you can merely bundle all of the actual costs associated with an asset.
2. If the cost segregation study is being performed on an existing building, you can estimate all of the actual costs associated with each asset using standard estimation techniques.

Either way, determining costs is an important part of the cost segregation study because there can be many underlying costs that are applicable to a particular asset. For example, a piece of equipment used in a restaurant's kitchen may be eligible to be classified as five-year property. And if there's electrical, plumbing or HVAC equipment specifically hooked into that asset, those costs could also qualify to be reclassified as five-year property.

A cost segregation study typically separates "real," or structural, property from "personal" property, such as decorative fixtures.

This example illustrates just how important it is that at least one of the people conducting the study have a thorough understanding of construction techniques and costs.

Take the plunge

With the economy not yet healthy, your construction company likely needs to expand its normal construction services. Offering cost segregation studies may be just what the doctor ordered.

After all, you'd not only be helping to provide a valuable service to your clients, but you'd also be building a new profit center that could bring in additional revenue for years to come. Perhaps it's time to consider adding cost segregation studies to your toolbox. ■

5 tips for building an incentive compensation program

As the economy continues to struggle, many construction companies are tightening their belts. Often, one of the first items on the chopping block is the annual bonus. But rather than eliminating such financial incentives, consider developing an incentive compensation program that's designed to help achieve your firm's goals.

Here are five tips for designing a program that works.

1. Reward the right things

Incentive programs frequently backfire because companies reward employees for the wrong things. Bonuses tied strictly to profits, for example, can motivate employees to adopt short-term strategies that increase their pay at the expense of the firm's long-term performance.

Unfortunately, these strategies usually sacrifice quality or safety to boost profits. Cutting corners on jobs may create short-term savings, but it will hurt the firm's bottom line over the long run. And safety issues can threaten a contractor's very existence.

It's important to take a holistic approach that ties compensation to all aspects of an employee's job. Suppose you're designing an incentive program for superintendents. Good supers get projects done on time and within budget — while maintaining quality and safety standards. But if you offer bonuses only for staying on schedule, then cost, quality and safety may suffer. Instead, make sure your program rewards excellence in all four areas.

2. Link pay to results

For incentive compensation to work, it's critical to reward employees for achieving quantifiable results that are within their control. Discretionary annual bonus plans are often ineffective because employees typically view bonuses as a "gift" rather than a reward for good performance. If year end bonuses become an expected component of compensation, not only are they poor motivators, but they can quickly turn into "demotivators" should they be reduced or taken away.

Establish performance goals that are attainable with hard work, but not too easily achieved. The goals should be simple and straightforward

enough so that employees understand both what they're expected to do and what they stand to gain if they do it. Sometimes companies create incentive pay formulas that are so complex and difficult to understand that employees become disillusioned with the program. As you develop your plan, seek input from eligible participants to gain employee buy-in.

3. Establish benchmarks

The only way to gauge employee performance is to measure your firm's recent performance and establish goals for improvement. You can't reward employees for reducing the time to completion unless you know what your average building time is on similar jobs.

To reward cost reduction, for example, you might measure decreases in labor hours or overtime. To reward quality improvement, you might track defects per square foot or amounts spent on warranty calls. The right benchmarks depend on the nature of your firm and its specific goals.

4. Time it right

For your incentive program to be truly effective, timing is everything. To maximize the impact, compensation should be linked closely in time with the performance that earned it — by paying bonuses quarterly, for example, rather than annually.

To align your employees' interests with the company's long-term goals, consider using stock options, restricted stock or other equity-based awards.

Consider deferring part of the bonus, however, to reflect future events that bear on an employee's performance. Some firms hold back a portion of the bonus and reduce it based on warranty expenses during the year following a project's completion, for example.

5. Think long term

To align your employees' interests with the company's long-term goals, consider using stock options, restricted stock or other equity-based awards. Giving employees an ownership stake in the business provides them with a financial incentive to stay with the company and maximize its long-term value.

To be effective, these incentives should vest over a substantial period of time. Otherwise, they might encourage actions that artificially boost the value of the company's stock or other equity interests in the short term.

Tying it all together

By tying compensation to performance, you can identify, motivate and retain your most valuable employees. And, unlike across-the-board bonuses, a carefully targeted incentive program can pay for itself. Some contractors have even convinced employees to accept lower base salaries in exchange for an opportunity to earn higher performance pay. ■

Weigh the pros and cons of IPD and BIM

There's been a lot of talk in the construction industry lately about integrated project delivery (IPD). IPD is a collaborative approach to construction projects that can help reduce costs, eliminate errors and delays, minimize waste, enhance efficiency and generally make projects more successful and profitable. IPD usually goes hand-in-hand with building information modeling (BIM), a technology that facilitates collaboration.

In theory, IPD and BIM have huge potential. But, in practice, neither has been widely adopted. Why? Because they require a dramatic change in mindset. Owners, architects and contractors must embrace a more collaborative relationship — a challenge in an industry in which these relationships are often adversarial. In addition, IPD contracts may raise thorny legal and risk management issues.

How IPD works

With an IPD arrangement, the owner, architect, general contractor — and, possibly, major subcontractors and suppliers — enter into a mutual contract. In some cases, the contract calls for parties to establish and co-own a single-purpose entity (SPE), often structured as a limited liability company. The parties collaborate from the earliest stages of the project, agreeing on project goals, target costs and allocation of responsibilities, risks and compensation.

Typically, the parties waive liability claims against one another (except for willful misconduct) and make decisions by unanimous consent, subject to arbitration or another dispute resolution mechanism. If successful, IPD enables parties to streamline schedules, control costs, reduce risks, minimize or eliminate change orders, and share the rewards of a more profitable project.

Role of BIM

BIM technology creates 3-D or even 4-D models that facilitate collaboration by enabling parties to view the completed project from different angles and to better understand spatial relationships between building components. BIM also incorporates specific materials and building information into the early stages of the design process and allows the parties to see how changes will affect the project as a whole.

By helping parties resolve design conflicts and other issues before construction begins, these models offer significant benefits, including higher quality, greater speed and productivity, and lower costs.

Handle with care

IPD and BIM technology may become the standard delivery method for construction projects. But if you're contemplating adopting this approach, proceed with caution.

IPD contracts must be drafted carefully to ensure they achieve the proper balance of risk and reward among the parties. And IPD arrangements — particularly SPEs — may raise licensing and other legal issues, as well as liability concerns that aren't covered by traditional insurance policies. So consulting your financial, legal and insurance advisors is a must. ■

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