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HEADLINE: Mandatory Arbitration in Construction Payment Disputes;
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BODY:

Arbitration recently has been garnering its fair share of attention. Congress is currently considering controversial legislation which would outlaw mandatory arbitration provisions in consumer, employment and franchise agreements.¹ Judges are more frequently coaxing litigants to submit their dispute to binding arbitration before an independent neutral as a means of clearing out their overcrowded dockets. Since the enactment of the Federal Arbitration Act more than 85 years ago and myriad state statutes governing arbitration, one thing has always remained constant: For an arbitration to exist, the parties must first agree to arbitrate.

² It now appears, however, that a statutory exception exists in New York which can force owners, contractors and subcontractors involved in payment disputes on private jobs to resolve them solely and exclusively via a binding arbitration proceeding.

With little fanfare last September, New York's Construction Contract Prompt Payment Law³ was amended to provide that violations of the statute may be submitted to binding arbitration at the request of an "aggrieved party." Its purpose is to expedite payment of all monies owed to those who perform contracting services on private construction projects where the size of contract between the owner and the general contractor exceeds \$150,000.

A party who claims a violation of the prompt payment requirements is required to give written notice of the violation to the other party.⁴ If they cannot resolve the matter themselves the aggrieved party may, within 15 days of the other party having received notice of the complaint, refer the matter to "expedited arbitration pursuant to the Rules of the American Arbitration Association."⁵ The party receiving the notice is required to participate in the arbitration proceeding--independent of the fact that (i) the party never agreed to arbitrate and (ii) its written contract with the aggrieved party contemplates, by silence or otherwise, that if a dispute arises, the parties will resolve their disputes in court. At the conclusion of the arbitration, the arbitrator is to render an "opinion and award regarding the violation."⁶ The arbitrator's decision is final and may only be vacated in accordance with *CPLR 75*.⁷

According to the statute, a claim that a party has "violated" the Prompt Payment Law can be submitted to an arbitrator. But exactly what types of claims does that encompass and what type of relief may the arbitrator grant? This ambiguity raises a number of questions about the scope of the arbitration proceeding. Consider the following:

If a project owner disapproves a portion of an invoice, but pays the undisputed amount and sends a written explanation showing the reasons and calculation of the withholding, can the contractor challenge the calculation and ask the arbitrator to rule all or part of the withholding was improper? Or is the arbitrator limited to ruling whether disapproval was timely and whether the reasons were forth in writing, without getting into the substance of the calculation?

If an invoice is disapproved because it includes a request for payment of extra work not yet approved, does the party seeking payment have the right to ask the arbitrator to determine that the extra work claims are valid and should be paid?

If an invoice is not disapproved timely, can the arbitrator rule that the party disapproving the invoice has waived any right to object and must pay the invoice without hearing evidence on whether the amounts invoiced are valid?

If the contract prohibits invoicing for extras or claims not incorporated via formal change orders, but does require any outstanding "claims" to be submitted with the final payment request, are those claims subject to arbitration if the final invoice including those claims is disapproved (or if not disapproved timely)?

Two Sets of Rules

The American Arbitration Association (AAA) has two sets of rules that would seem applicable to disputes under the statute, the Commercial Arbitration Rules and the Construction Industry Arbitration Rules.⁸ While both sets of rules contain procedures designed to shorten the time for the proceedings, only the procedures under the Commercial Rules are referred to as "Expedited Procedures."⁹ The Construction Rules use the term "Fast Track Procedures."¹⁰

The one significant difference is that the Fast Track Procedures call for a preliminary telephone conference and require the hearings be closed, meaning all hearings have been held and all evidence and arguments have been submitted to the arbitrator with 45 days after a preliminary conference.¹¹ Both sets of procedures apply where the claim or counterclaim does not exceed \$75,000 or where "the parties agree otherwise."¹² All claimed violations of the Prompt Pay Law are subject to expedited arbitration regardless of the amount in dispute.

Presumably, subject to the filing of a demand by the "aggrieved party," by participating in a project subject to New York's Prompt Payment Law the parties are deemed to have adopted the AAA's expedited procedures.

Other features of the expedited procedures are limits on time extensions to respond to claims and counterclaims,¹³ telephone notice of hearings,¹⁴ selection of the arbitrator by the AAA if the parties cannot agree,¹⁵ exchange of exhibits two days before hearings,¹⁶ a presumption the dispute will be submitted solely on documents if the claim is less than \$10,000,¹⁷ a hearing within 30 days of the arbitrator's appointment,¹⁸ a presumption the hearing will not exceed one day¹⁹ and awards to be rendered within 14 days from the close of the hearings.²⁰ It remains to be seen whether the expedited process will allow for a full and fair hearing of what could be factually and legally complex payment disputes involving multiple parties.

Other Changes

In addition to the provisions regarding arbitration of disputes, other significant changes to the Prompt Payment Law include:

- Mandating payment by an owner of interim or final invoices within 30 days of approval of the invoice;

- Prohibiting contractors and subcontractors from withholding liquidated damages from progress payments; and

- Making void and unenforceable contract payment provisions that differ from those in the statute or provisions which state that arbitration as provided for in the statute is not available.^{21,22}

As originally enacted, the statute allowed the owner to set the time for payment of an invoice to the contractor. Under the new provisions the owner must pay the contractor within 30 days of approval of an invoice, unless payment is con-

tingent upon lender approval in which case payment is due seven days after the lender has provided the funds to the owner.²³

If an invoice has been disapproved in whole or part by the owner the only amount which may be withheld is an amount sufficient to pay the costs and expenses to cure the defects set forth in the written explanation for withholding payment. The owner may also withhold an amount sufficient to cover liquidated damages if provided for in the contract.²⁴

Withholding Payment

Contractors are required to pay subcontractors and suppliers and subcontractors are required to pay anyone downstream of them the full or proportionate amount of the money received from the owner within seven days of receiving payment.²⁵ Contractors and Subcontractors can withhold payments to those downstream for reasons similar to those for which an owner can withhold payment, such as defective work. However, contractors and Subcontractors can no longer withhold liquidated damages based on the liquidated damages set forth in the owner/contractor agreement. The statute is silent as to whether liquidated damages can be withheld if the subcontract provides for liquidated damages.²⁶

A contractor intending to withhold money received from the owner or must, prior to the date payment is due i.e., within six days of their receiving payment, provide to the subcontractor and the owner a written notice setting forth the amount withheld, the reasons for the withholding citing the specific contract clauses and provisions of the statute justifying the withholding, the remedial action that must be taken to receive payment and any documents or waivers necessary. While the statute does not expressly require it, a subcontractor intending to withhold money due a sub-subcontractor or supplier would be well-advised to provide a similar written notice.²⁷

Section 756-b, entitled "Remedies," contains new provisions allowing for violations of the statute to be submitted to arbitration at the request of an "aggrieved" party. As originally enacted the remedies included interest on late payments of at least 12 percent per year²⁸ and the right to suspend work due to a failure to timely approve or disapprove an invoice.²⁹

Conclusion

Apparently, the supporters of the recent revisions to the Prompt Payment Law required mandatory arbitration of payment disputes because arbitration is viewed as a speedy, expeditious and less costly way to resolve disputes. That may well be the case, but it does raise a serious issue. The revisions run counter to the well-settled notion that parties cannot be compelled and must agree to use arbitration as the forum to resolve their disputes. No doubt it is just a matter of time before a disgruntled owner, contractor or subcontractor forced into an arbitration challenges the constitutionality of the mandatory arbitration provisions of the Prompt Pay Law. The claim will be that no one, not even the New York State Legislature, may take away their right to a jury trial.³⁰ A law intended to reduce litigation may very well keep lawyers and courts busy for some time.

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Endnotes:

1. The proposed federal Arbitration Fairness Act was re-introduced last year by Sen. Russell Feingold (D-Wi) (S. 931) and Rep. Henry Johnson (D-Ga) (HR 1020). Both versions of the bill are presently in committee.

2. With the exception of unilateral arbitration clauses which New York courts enforce because one party has agreed to permit the other party to decide whether they should proceed to arbitration (See e.g., *Sablowsky v. The Edward S. Gordon Company Inc.*, 73 N.Y.2d 133, 538 N.Y.S.2d 513, 525 N.E.2d 643 (N.Y. 1989)) and "fee arbitration" statutes requiring attorneys to notify their clients of the option of proceeding to arbitration to resolve attorney's fees disputes, unless the parties' agree to arbitrate, it is well-settled arbitration cannot occur.

3. Also known as General Business Law 756-758.

4. GBL 756b(3)(a).

5. GBL 756b(3)(c).
6. GBL 756b(3)(d).
7. GBL 756b(3)(e); *CPLR 7501 et. seq.*
8. Available at www.adr.org.
9. Commercial Arbitration Rules, Expedited Procedures, E-1 to E-10.
10. Construction Industry Arbitration Rules Fast Track Procedures F-1 to F-13.
11. F-7; F-12.
12. Commercial Rules, R-1; Construction Rules R-1.
13. E-1.
14. E-3.
15. E-4(b).
16. E-5.
17. E-6.
18. E-7.
19. E-8.
20. E-9.
21. GBL 757(3)(4). Other changes include reducing the cost of projects to which the statute applies from \$250,000 to \$150,000, and changing the size of certain residential projects to which the statute will apply.
22. Some more background about the Prompt Payment statute: It applies to most private construction projects, with certain exceptions for residential projects and projects involving the World Trade Center site GBL 756(1); 756e. The project owner is required to either approve or disapprove an invoice within 12 business days. An owner may disapprove all or part of an invoice for reasons set out in the statute, such as unsatisfactory progress, defective work, a failure to comply with a material provision of the contract or failure to make payments for labor or material. The reasons for disapproval must be set forth in writing and delivered to the contractor GBL 756a(2)(a)(i). Contractors and subcontractors must also approve or disapprove invoices within 12 business days and can withhold submitting an invoice to the owner or contractor for similar reasons GBL 756a(2)(a)(ii).
23. GBL 756a(3)(a)(i).
24. GBL 756a(3)(a)(iv).
25. GBL 756a(3)(b)(i).
26. GBL 756a(3)(b)(ii).
27. GBL 756a(3)(a)(iv).

28. GBL 756 b (1)(a) and (b).

29. GBL 756b(2)(a) and (b).

30. U.S. Constitution, Amendment VII; *New York Constitution, Article VI* 818.

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