

The Notice of Contract Mechanism: How Contractors Can Avoid Double Payment

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As the economic crisis stemming from the coronavirus pandemic unfolds, it is ever more important that contractors and subcontractors protect their payment rights and avoid the risk of double payment; i.e., the risk of having to pay twice for the same work.

On private projects in North Carolina, one of the most common methods for protecting payment rights and defending against double payment claims is the Notice of Contract mechanism. The Notice of Contract mechanism is also one of the most frequently misunderstood mechanisms within our lien law.

Double Payment

Double payment arises from the "contracting-chain" nature of large construction projects (See Exhibit A). Construction projects typically involve an owner retaining a general contractor or construction manager to perform the construction. The general contractor typically does not perform the work itself but rather retains subcontractors to perform different scopes of the total construction package. Those subcontractors retained directly by the general contractor are known as first-tier subcontractors. Those first-tier subcontractors will typically retain subcontractors themselves, those subcontractors being known as second-tier subcontractors. It is not uncommon to have subcontractors or suppliers as "remote" as the second or third-tier on large construction projects.

Construction projects with subcontractors (including suppliers) at the second and third-tier levels confront the risk of default by parties in the middle tiers, particularly default by first-tier subcontractors. The default often occurs where a first-tier subcontractor is paid by the general contractor but does not flow payments down to its second-tier subcontractors. This, in turn, creates an issue with who will bear the loss of a first-tier subcontractor's default. Put simply, if the second and third-tier subcontractors perform work for and through a first-tier subcontractor, the first-tier subcontractor is paid for that work, and the first-tier subcontractor then defaults (e.g., by going bankrupt or by leaving the country and making themselves "unavailable" to pay anything) who carries the risk of that loss, the general contractor or the second and third-tier subcontractors? In North Carolina on private projects (i.e., projects not owned by the federal or state government), absent strict adherence to the Notice of Contract mechanism, the risk of loss is on the general contractor.

The Notice of Contract mechanism came about because of an ambiguity in North Carolina's lien statute. Generally speaking, contractors have rights to lien the real property; subcontractors have rights to lien the project funds. However, in addition to their rights to lien project funds, subcontractors also have the right to step into the shoes of the general contractor and—through the magic of the legal mechanism known as "subrogation"—assert the general contractor's lien on real property. When subcontractors were given the right to assert this subrogation lien on real property, the vast majority of construction lawyers understood that the right to assert the lien on real property by second or third-tier subcontractors was limited by the subcontractor's right to a lien upon funds. If a first-tier subcontractor had been paid in full, then the second- and third-tier subcontractors working for it would have no lien on funds (because no funds were owed to the first-tier subcontractor). Thus, the assumption was that because the second and third-tier subcontractors had no lien upon funds, they had no right to a subrogation lien on real property.

To the surprise of many of these construction lawyers in 1991, in the case of Electric Supply Co. of Durham, Inc. v Swain Electrical Co., Inc., 328 N.C. 651, 403 S.E.2d 291 (1991), the Supreme Court of North Carolina held that based on ambiguous wording in the lien statute, a second and third-tier subcontractor's right to a subrogation lien on real property was limited only by the amounts owed from the owner to the general contractor without regard to what, if anything, was owed to the first-tier subcontractor from the general contractor. This rule created the risk of double payment on the part of the general contractor on private projects in North Carolina.

The double payment risk arises when a general contractor pays a first-tier subcontractor for work performed by second or third-tier subcontractors working for the first-tier subcontractor. If the first-tier subcontractor defaults (or makes itself unavailable by flying off to Tahiti with the money), the second and third-tier subcontractors' lien on funds rights are limited by the amount owing to the first-tier. In this example, that amount is \$0 or nothing since the first-tier subcontractor has been paid in full. However, the second and third-tier subcontractors can also assert a subrogation lien on real property so long as money is owed from the owner to the general contractor.

This is the double payment problem on private projects: The second and third-tier subcontractors can recover through enforcement of their subrogation lien on real property, without regard to the amount, if any, owed from the general contractor to the first-tier subcontractor. Because the general contractor already paid the first-tier subcontractor for the work at issue, the general contractor is effectively compelled to pay twice for the same work. Put another way, the second and third-tier subcontractors can recover, through the subrogation lien on real property, without regard to the fact that the general contractor has already paid the first-tier subcontractor for the work and that the general contractor owes the first-tier subcontractor nothing further. The owner will not be at risk of double payment. The general contractor will be forced to either pay the second and third-tier subcontractors or have their subrogation lien on real property enforced up to the amounts otherwise owed from the owner to the general contractor. In simplest terms, the general contractor suffers a loss in the amount of the claims of the second and third-tier subcontractors, limited only by the amount owed from the owner to the general contractor at the time the subrogation lien is asserted.

In response to this double payment problem, the General Assembly, as is often the case with our lien law, did not directly overturn the Supreme Court. Instead, it added a new section to the lien law that allows the general contractor to utilize the Notice of Contract mechanism to shift the risk of loss from first-tier subcontractor defaults onto second and third-tier subcontractors. This allows the general contractor to avoid the double payment.

How Notice of Contract Works

Step 1: General Contractor Plays First Card with Notice of Contract

Under the Notice of Contract mechanism, set forth in N.C. Gen. Stat. § 44A-23, a general contractor wishing to protect itself from double payment on a private project, will first post and file a Notice of Contract. A Notice of Contract contains the following items:

1. Name and address of the general contractor.
2. Name and address of the owner of the real property at the time the Notice of Contract is recorded.
3. General description of the real property to be improved.
4. Name and address of the person, firm, or corporation filing the Notice of Contract.

A sample is shown in Exhibit B. The Notice of Contract must be both posted at a visible location on the job site and filed with the clerk of court for the county in which the project is located. This must be done within 30 days of the latter of i) the building permit issuing, or ii) full execution of the contract between the owner and the general contractor.

Posting the Notice of Contract inside the jobsite trailer will probably not count as a visible location because the jobsite trailer is not always accessible. A good rule of thumb is to post the Notice of Contract in a location where a material delivery truck driver could easily hop out, locate the Notice of Contract with little or no inquiry, and take a photo of the Notice of Contract without hassle. Further, although the statute does not require it, it is recommended that the general contractor take date-stamped photos of the Notice of Contract posted at the visible location at the job site. This will help prove that the Notice of Contract was, in fact, posted where and when it was required.

Step 2: Subcontractor Responds with Notice of Subcontract

Any second or third-tier contractor who wishes to protect itself from the risk of a first-tier's default in response to the Notice of Contract must serve a Notice of Subcontract on the general contractor. The Notice of Subcontract must be served in the same manner as a complaint, i.e., FedEx, UPS, or registered mail with receipt confirmation or by personal delivery by a sheriff's deputy. The Notice of Subcontract must contain the following information:

1. Name and address of the subcontractor.
2. General description of the real property to be improved.
3. General description of the subcontractor's contract, including the names of the parties thereto; and a general description of the labor and material performed and furnished thereunder.
4. A statement of the following: "Request is hereby made by the undersigned subcontractor that he be notified in writing by the contractor of, and within five days following, each subsequent payment by the contractor to the first tier subcontractor for labor performed or material furnished at the improved real property within the above descriptions of such in paragraph (2) and subparagraph (3)(ii), respectively, the date payment was made and the period for which payment is made."

A sample Notice of Subcontract is shown in Exhibit C.

Step 3: General Contractor Plays Last Card with Continuing Notices of Payment

If the general contractor posts Notice of Contract and the second and third-tier subcontractors provide Notice

of Subcontract, then the general contractor is put back in the position it was in had it never posted Notice of Contract. In order to retain the benefit of the Notice of Contract mechanism, the general contractor must play the last card. The general contractor must, each time it pays the first-tier subcontractor, provide a Notice of Payment to each and every second and third-tier subcontractor who has provided a Notice of Subcontract. The Notice of Payment must be sent within five (5) days of the payment and must be sent via FedEx, UPS, or registered mail with receipt confirmation or by personal delivery by a sheriff's deputy. A sample Notice of Payment is shown in Exhibit D.

If all of these listed steps above occur, then the second and third-tier subcontractors are prohibited from asserting a subrogation lien on real property. This effectively shifts the risk of a first-tier subcontractor default from the general contractor to the second or third-tier subcontractors and eliminates the general contractor's double payment risk. The second and third-tier subcontractors must protect themselves by using the information provided through the Notices of Payment. As soon as they receive notice of a payment to the first-tier, they should immediately lien funds if they do not receive a corresponding payment.

Note that the owner is never at risk of double payment, and the Notice of Contract mechanism does not interfere with the payment rights of the subcontractors against the first-tier subcontractor. Note also that the first-tier subcontractor is never implicated in the Notice of Contract mechanism, at least for purposes of providing notices. Note also that in the case of a private payment bond, the Notice of Contract mechanism will not alter the obligations under that bond.

Frequently Asked Questions

Question: I am the general contractor. What if I post the Notice of Contract at the jobsite and fail to file it with the clerk of court?

Answer: You have failed to comply with the requirements of the statute and therefore, will not have the protection provided by N.C. Gen. Stat. § 44A-23. Posting without filing is of no effect. Similarly, filing without posting is of no effect. Both must occur.

Question: I posted Notice of Contract, and after making several payments to the first-tier subcontractor, received a Notice of Subcontract from one of its second-tier subcontractors. Should I provide those second-tiers with Notice of Payment when I make further payments, and have I lost the benefit of a Notice of Contract because I already paid the first-tier?

Answer: You should provide Notice of Payment to the subcontractors each time you pay the first-tier subcontractor subsequent to receiving the Notice of Subcontract. You have not lost the benefit of the Notice of Contract mechanism, although the statute is not explicit on this point. A close reading of this statute suggests that the Notice of Payment obligation is triggered only after receiving the Notice of Subcontract. You cannot practically be obligated to file a Notice of Payment to a second or third-tier subcontractor who has not provided Notice of Subcontract. However, if the Notice of Subcontract is provided at any point subsequent to the Notice of Contract being provided, then any subsequent payments to the first-tier subcontractor must have Notice of Payments sent within five days to the second or third-tier subcontractors.

Question: I have one contract with the owner, but it is for separate buildings, each of which has its own permit. Do I need separate notices of subcontract?

Answer: Ideally, the permit would follow the contract, and thus you would have one permit per contract with the owner. In this situation, however, it would probably be best to follow the subcontracts. If there are different subcontracts relating to each permit, then you should have a separate Notice of Contract for each

permit. However, if you will have one subcontract with each first-tier subcontractor for the entire project, it probably makes sense only to have one Notice of Contract posted and filed.

Question: I provided notice to the lien agent. Doesn't that do the same thing as Notice of Contract or Notice of Subcontract?

Answer: No, the two mechanisms are totally different. You should certainly provide notice to lien agent, but doing so protects other aspects of your own lien rights—it does not satisfy the requirement to post Notice of Contract if you are a general contractor or to provide Notice of Subcontract if you are a second or third-tier subcontractor.

Question: I'm a first-tier subcontractor and was paid in full by the general contractor. The general contractor didn't post the Notice of Contract. Does that mean I'm off the hook and can make the general contractor pay my subcontractors?

Answer: No. As a first-tier subcontractor, you remain liable for your obligations. Notice of Contract is not for your benefit. Its purpose is to help general contractors and second and third-tier subcontractors manage the risk of your default. You will be required to pay your subcontractors what you owe them, or the general contractor will be entitled to recover from you what it had to pay them to address their claims, which you wrongfully failed to pay.

Question: I work for a general contractor, and I handle the checks. Sending out certified letters each time I pay a first-tier subcontractor is expensive and time-consuming. This doesn't seem like something that is worth it?

Answer: Yes, it is. It will only take one instance of your employer having to double-pay a five-figure (or even six-figure) amount, plus attorneys' fees, for them to quickly determine that it is "worth it."

Question: I'm a fourth-tier supplier on a large construction project. One of my deliverymen found a Notice of Contract posted at the jobsite. Should I send in a Notice of Subcontract?

Answer: No. While there is no harm from doing so, there is also very little benefit. Fourth-tier and more remote subcontractors and suppliers do not have a right to assert a subrogation lien on real property and therefore, cannot force double payment in the same way that a second or third-tier subcontract can. You should be vigilant about getting paid timely, asserting a lien upon funds, and asserting a payment bond claim.

Question: Is the Notice of Subcontract the same thing as the Notice of Public Subcontract? If not, what's the difference?

Answer: Not exactly. Notice of Subcontract is used on private (nongovernment owned projects). There is a mechanism on state-owned projects in North Carolina that is similar to but different from the Notice of Contract mechanism. On state-owned projects, the second-tier and more remote subcontractors must provide a Notice of Public Subcontract to protect their bond rights.

Question: I'm a first-tier subcontractor. Should I provide a Notice of Subcontract in response to the posting of a Notice of Contract?

Answer: No. As a first-tier subcontractor, you cannot force double payment from a general contractor—the general contractor already having paid you is a defense to your payment claim. Similarly, the general contractor already knows you're there, so there is no need to "wave that flag."

Question: I'm the project owner. Should I be using the Notice of Contract mechanism and, if so, why?

Answer: Yes. The statute allows you to post Notice of Contract. Although you are not technically at risk of having to pay twice for the same work, you will want a lien-free project at the end of the construction work. Having another tool to thwart or defend against subcontractor liens against the real property is, therefore, beneficial. It is recommended that the owner include a provision in the contract with the general contractor requiring the general contractor to post and file Notice of Contract and to follow the Notice of Contract process otherwise.

Question: If there is a payment bond on the project, does the Notice of Contract affect claims against that bond, and, if so, how?

Answer: No, the Notice of Contract mechanism or following it will have no effect on claims against the bond or defenses thereto. Claims against the bond and defenses thereto will be governed by the terms of the bond itself (a slightly different rule applies on government projects, which includes a requirement that the bond be obtained).

Question: I'm a second-tier subcontractor. I sent in a Notice of Subcontract when I saw the Notice of Contract posted at the jobsite. But, I never received any notices of payment when the general contractor paid the first-tier subcontractor for whom I was working. I asserted a subrogation lien on real property, but the general contractor is now saying that they were paid in full by the owner and that the general contractor provided a final lien waiver to the owner, both before I filed my subrogation lien on real property. Based on what you said above, should I still be able to recover since the Notice of Contract process wasn't complied with by the general contractor?

Answer: No. Although the general contractor did not strictly comply with the Notice of Contract process, such failure just puts the general contractor back in the position they would have been if they had never posted Notice of Contract. If what the general contractor is telling you is true, your claim fails for two reasons: 1) as noted above, your subrogation claim is still limited by the amounts owed from the owner to the general contractor which, under these facts, is \$0; and 2) the Notice of Contract statute also contains a provision that says the general contractor can waive both its lien rights and your subrogation lien rights at any point prior to you fully perfecting your subrogation lien. (Note, for this reason, subcontractors should, regardless of whether Notice of Contract is posted, still assert their lien upon funds and their subrogation lien on real property as soon as possible after completing their work).

Question: I'm a subcontractor. I thought I could lien funds at any time and that I had 120 days from the last furnishing to assert a lien on real property. Why do I need to be in a hurry?

Answer: As noted in the previous response, payment from the owner to the general contractor is a defense to a lien upon funds. Similarly, there is no right to a subrogation lien if the owner has paid the general contractor in full or if the general contractor has provided the owner with a final lien waiver.

Conclusion

If you, as a general contractor, do not file a Notice of Contract mechanism on private projects, then you are at risk of double payment. You should be like Nike, and just "do it." As a subcontractor, if you do not provide Notice of Subcontract on private projects where Notice of Contract is posted and filed, then you are at risk of being left with the proverbial bag in the case of a first-tier subcontractor default. If you have any questions concerning the Notice of Contract mechanism or payment rights and defenses on construction projects, you should contact a Ward and Smith construction attorney at your earliest convenience.

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