



CONSTRUCTION DISPUTES

problems in payments to subcontractors

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Is subcontracting easier? The effects of the amendment of Art. 647¹ of the Civil Code two years after adoption

PAWEŁ MAZUR, MACIEJ ZYCH

Art. 647¹ of the Civil Code, providing for the investor's secondary liability for the contractor's debts to subcontractors, was introduced into the Polish legal system in 2003. In April 2017, the parliament amended it thoroughly in adopting the Act Amending Certain Acts to Facilitate Debt Recovery. Two years after implementation, we try to answer the question whether the title of the amending act corresponds to reality and subcontractors really have a better chance of receiving payment for their work.

Under current law, the investor is jointly and severally liable with the general contractor for payment to the subcontractor if the contractor previously notified it of the subcontractor (or the subcontractor provided notice of a further subcontractor) and indicated the scope of the works entrusted to the subcontractor, and the investor did not object within 30 days of notification. A separate notification is not necessary if a given subcontractor and the scope of work to be carried out are specified in the contract with the general contractor. This was not expressly provided for in the earlier regulations, but such a mechanism could be inferred from them.

From subcontractors' point of view, the determination that the investor's joint and several liability arises only after notification is certainly a negative change. The decisions under the previous law often recognised retroactive effect of consent. Now, as a precaution, a subcontractor must assume that works carried out before notification will not be protected.

The replacement of the requirement of the investor's "consent" by a notification mechanism allowing objections to be raised also leads, albeit indirectly, to adverse consequences for subcontractors. Based on the previous legal situation, there was already well-established case law holding that the investor's consent could be expressed in any way, including implicitly, which was very beneficial for subcontractors, as it significantly increased their chances in a court case. The current wording of Art. 647¹ of the Civil Code seems to exclude this solution, although there are some decisions of the lower courts supporting the previous line of ruling despite the change of regulations.

On the other hand, from the subcontractor's point of view, it should be noted on the plus side that the notification may concern all construction

works regardless of the legal qualification of the contract, and may also come directly from the subcontractor, and not, as before, only from the general contractor. However, on the other hand, the requirement to specify the detailed subject of the subcontractor's works imposes an obligation on it to precisely define the scope of works even before commencement, which in practice can be very difficult (especially when the project is poorly prepared).

A certain inconsistency of the parliament is that, unlike in the analogous provisions on public procurement (Art. 143c of the Public Procurement Law), the literal wording of the provision excludes from the scope of the investor's joint and several liability suppliers of materials and entities providing services closely related to construction works, such as design services and geological works. Although the decisions from the lower courts have increasingly broadened the concept of "subcontractor of works," and the concept sometimes also includes suppliers of construction materials and service providers, it is a diverse and unpredictable concept. It is a pity that the parliament did not resolve this problem directly, in the wording of the act, and did not unify the rules governing the public and private sectors.

It should also be noted that under the current wording of Art. 647¹ §3 of the Civil Code, the fee agreed between the general contractor and the subcontractor, which may not exceed the fee provided for the contractor for the same scope of works in the agreement with the investor, sets the upper limit of the investor's liability. This means that even if the subcontractor succeeds in increasing the agreed fee through negotiations or legal proceedings, the liability of the investor will remain at the original level, unless the investor accepts the notification of an extension of the scope of works or a change in fee.

Arguably a subcontractor could claim payment from the investor for additional works not covered by the notification under provisions on unjust enrichment, but this solution does not guarantee success and in principle is only possible if the investor has not paid the general contractor for those works.

The parliament's abandonment of the previously planned requirement of written form under pain of nullity for contracts between the contractor and subcontractors, which also raised many doubts in practice, makes life easier for subcontractors. Currently, written form is used only for evidentiary purposes, which in any case does not apply in disputes between businesses. Thus, one could imagine that a subcontractor will notify the investor of an informal (oral or implicit) contract for additional or replacement works concluded with the general contractor. As long as the subcontractor indicates the scope

of works and, in a possible trial, is able to prove that the general contractor commissioned it to perform the works, such a suit against the investor will have some hope.

The arbitrariness of objections to hiring a subcontractor is a significant practical problem for both the subcontractor and the general contractor. According to the justification of the draft amendment, an investor may object for any reason and thus evade joint and several liability. Under the new rules, practice has shown that investors eagerly exploit this possibility by opposing subcontractors often in the last days before the deadline, and multiple times for the same scope of works. This greatly weakens the position of the subcontractor and provides an additional argument for the subcontractor to protect itself in the contract with the general contractor in the event of objection from the investor. Hopefully, despite the different wording of the regulations, as under the old legal status the courts will require that an effective investor objection must be justified, although at this point it is difficult to determine whether that will be the case.

To sum up, it seems that the parliament's objective was not to make life easier for subcontractors, but to balance the interests of investors and subcontractors and to eliminate the discrepancies that had arisen in the previous legal situation in the legal literature and in the case law. So far, experience has shown that none of these objectives have been fully achieved. However, the actual effect of the changes will only become apparent in the case law, which may make some adjustments to the direction taken.

Paweł Mazur, adwokat, Maciej Zych, adwokat, Dispute Resolution & Arbitration practice, Wardynski & Partners

Guarantee of payment or guarantee of withdrawal from contract?

DR MARCIN LEMKOWSKI

Art. 649¹–649⁵ of the Civil Code is intended to ensure that the security in the form of a payment guarantee for construction works provided at the investor's request secures timely payment of the contractor's fee. However, one may suspect that in practice this instrument is used for a completely different purpose.

Statutory right to security

The parliament sometimes decides to grant one of the parties to a contract special security for its claims. This is the case, for example, in a lease agreement, where the lessor is entitled to a statutory pledge on the movable assets of the lessee brought into the premises to satisfy the lessor's claim for rent (Art. 670 §1 of the Civil Code). A similar solution has been applied in the case of a construction works contract, where the party who may request security is the contractor and a payment guarantee must be provided by the investor (or, more precisely, a bank or insurer acting on its behalf). This guarantee is to secure timely payment of the contractor's fee (Art. 649¹ §1 of the Civil Code).

A harsh sanction

The parliament has defined in a special way the sanction for failure to obtain a payment guarantee. According to Art. 649⁴ §1 of the Civil Code, if a contractor does not obtain the requested payment guarantee within the period it indicates of no less than 45 days, the contractor is entitled to withdraw from the contract due to the fault of the investor, with effect on the date of withdrawal. Obtaining a guarantee is understood in practice to mean not just issuance of a guarantee letter by the guarantor, but also delivery of the guarantee to the contractor, before the expiration of the set deadline.

High costs

A bank guarantee is an expensive form of security. In its judgment of 27 November 2006 in case K 47/04, the Constitutional Tribunal found that the cost of a guarantee may amount to even 6% of the project value. The legal literature shows slightly different values of 2–4% per year. Nevertheless, these amounts are still significant. Considering that infrastructure projects often amount to tens or hundreds of millions of zlotys, the costs of guarantees become equally astronomical. And the parliament has decided that these costs are to be borne half and half by the concerned parties (Art. 649¹ §3 of the Civil Code), even though their origin is decided solely by the contractor and they are incurred solely in the interest of the contractor.

How it works in practice

At the beginning of April, our law firm held a seminar entitled “Subcontractor, general contractor and investor: Joint construction, various interests—legal problems in payment of subcontractors.” We asked the participants whether they deal with payment guarantees in practice. They said that as contractors or subcontractors enjoying a right to protection in relation to the general contractor under Art. 649⁵ of the Civil Code, they do exercise this

right, but only incidentally. It rarely happens that a guarantee is requested at the very beginning of cooperation, at the time the contract is concluded. A contractor has no reason to suspect from the very beginning that the investor will refuse to pay on time, and additionally does not want to bear half of the cost of this security, which, as indicated, may reach millions of zlotys. Therefore, it is not surprising that contractors do not immediately exercise the right vested in them by the parliament.

Contract is one thing, construction another

However, the reality is that what actually happens on the construction site quickly begins to diverge from the contractual arrangements. Schedules become outdated in terms of both time and subject matter. There are additional, substitute works; there are unforeseen circumstances. This happens for instance because even the best design is only a design, and always loses in the confrontation with life, which turns out to be more complex than the most perfect drawings, assumptions or calculations. As a result, the interests of the parties on many construction sites quickly begin to clash: the contractor does not want to undertake further works for fear of not receiving approval, and then payment; delays occur, trust erodes, and correspondence begins to be exchanged in order to secure the best possible legal position for potential future litigation.

A nuclear option

It is often only in such a situation that the contractor realises it has a very effective tool at its disposal, sometimes called the “nuclear option”: it can demand a payment guarantee, not to secure timely payment of its fee, but to have a solid, undeniable basis for withdrawing from the contract and thus exiting an unsuccessful and complicated project. As is also seen in the case law, it is at such moments that a demand for a payment guarantee is typically asserted, and if the guarantee is to be provided within 45 days, on the 46th day the investor receives a statement from the contractor withdrawing from the contract pursuant to Art. 649⁴ §1 of the Civil Code. In a conflict situation, even if the investor has such a possibility, it usually does not decide to obtain a payment guarantee, as it fears that it will be immediately exercised by the contractor, despite a dispute between the parties.

Was this the purpose?

No definitive conclusions may be drawn from a few statements by members of the construction sector to the effect that the right to obtain a payment guarantee is not being used for its intended purpose, even if supported by the available case law. Further research is needed, including quantitative re-

search, to verify this hypothesis. Nonetheless, we may suspect that often the demand for a payment guarantee is more about a guarantee of withdrawal from the contract, rather than payment. This situation approaches circumvention of law (Art. 58 §1 of the Civil Code), especially if the contractor could not invoke a basis for withdrawal from the contract other than the one provided for in Art. 649⁴ §1 of the Civil Code. After investigating this problem, the parliament should consider whether the existing solutions need to be changed, especially with respect to the sanction for not providing the requested security.

Dr Marcin Lemkowski, adwokat, Dispute Resolution & Arbitration practice, Wardynski & Partners

How to recover money paid directly to subcontractors?

AGATA JÓŹWIAK

The parliament has granted subcontractors a high level of protection. The provisions on joint and several liability are strict for the investor and often in practice mean a risk of double payment for the same thing: the first time to the general contractor and the second time to the subcontractor. Therefore, the investor should be able to recover from the general contractor the sums paid directly to subcontractors.

The investor, the general contractor, and the subcontractors have a common goal: to complete the project. Unfortunately, this is usually where the elements connecting them come to an end. The common goal often becomes obsolete during the construction process, especially in the event of a serious conflict between the parties. During the construction process, important interests of its participants clash, which often leads to disputes.

The method and speed of their resolution depend mainly on the good will of the parties. However, to avoid relying on good will, it is necessary to protect oneself properly and in advance. The investor, as the host of the construction project, has a special role to play there. After all, it is the investor who is responsible for preparing the construction contract and should frame it in a way that provides the investor adequate protection, but does not become a trap for the contractors. This may help to avoid problems with the completion of the project and thus lengthy litigation giving rise to a high degree of uncertainty. The most efficient projects are those involving entities open to dialogue and amicable handling of matters.

In the process of settling with subcontractors, the attitude of the general contractor will be of particular importance. Therefore, an investor operating outside the public procurement regime should carefully choose a partner, and it may have cooperated with the contractor for several years. It is important that, apart from experience and appropriate preparation, the general contractor is in good financial condition. Financial problems of the general contractor may bring the investor many difficulties (in the course of the project and settling with the subcontractors).

Recourse problems

The possibility of pursuing recourse against a contractor is not uniformly recognised in the case law and legal literature. The strictest position says that without separate contractual reservations, on the basis of the Civil Code itself, there is no such recourse. Some take the view that the investor is entitled to reimbursement of half of what it paid to subcontractors. The most advantageous position for the investor gives it the possibility of full reimbursement of amounts paid directly to subcontractors.

In order to avoid any risks associated with these discrepancies, it is best to explicitly provide for the possibility of reimbursement in the contract. In addition, it may be stipulated that the general contractor is also obliged to reimburse the investor for other costs incurred in relation to subcontractors' claims, e.g. costs of court proceedings, interest, legal fees for the subcontractor's claim, etc. This will allow the risk of litigation with the subcontractor to be passed to the general contractor and give the investor greater comfort in assessing the subcontractor's claims.

Statutory setoff and contractual setoff

Setoff, which should also be expressly provided for in the contract, will also be a good instrument for recovering sums paid directly to subcontractors. Setoff will be possible if the investor has not yet paid the general contractor all its fees. According to the Civil Code, the possibility of setoff arises only when the claim (the investor's claim) presented for setoff is already due. This means that the investor makes a setoff against the general contractor's fee only after a direct payment has been made to subcontractors. It is also important to remember to follow the formalities and to send a notice of setoff to the contractor. The effect of the setoff will occur only when the contractor is served with this document.

To speed up the possibility of setoff, it is worth considering modifying the statutory rules of that institution in the contract. However, in this case, care is required to avoid exposure to an accusation of ineffectiveness of the con-

tractual terms. A provision that setoff is possible as soon as the subcontractors have made their claim to the investor would be beneficial for the investor.

Creditors' race

If an investor chooses to make a setoff, it should not delay. It may turn out that the fee of the general contractor (with whom the investor wants to set off sums paid directly to subcontractors) will be attached by a bailiff executing on behalf of the general contractor's other creditors. In such a situation, the investor is obliged to pay the bailiff the fee due to the general contractor and can no longer exercise the claim itself. The bailiff will then pass on the proceeds to another creditor.

Therefore, other entities may anticipate the investor's moves and prevent the investor from asserting setoff to satisfy its claim. The situation is different if setoff by the investor precedes the execution seizure. Then, the investor only has to declare to the bailiff that the seized claim does not exist, because it was extinguished by setoff. These problems will be very likely in the case of a general contractor with financial problems (lack of assets, loss of liquidity, numerous court and enforcement proceedings in progress). In such situations, investors are served with an avalanche of attachments by bailiffs of general contractors' fees. Therefore, the investor's sluggishness in asserting setoff may have irreversible and very painful consequences for the investor.

Guarantee deposit and the risk of its seizure by the bailiff

A guarantee deposit (5% of the value of each invoice to be paid, retained by the investor to cover, among other things, subcontractors' claims) is also a useful instrument. This is money that the investor actually has and it is easy to use.

However, the possibility of enforcement seizure of the deposit withheld by the investor is not uniformly recognised in practice. The bailiffs often refer to its legal nature and claim that it constitutes a part of the fee due to the contractor, which will become due only in the future (when the prerequisites for the return of the deposit are realised). Therefore, they accept the admissibility of an enforcement seizure of the deposit. Such a seizure will deprive the investor of that security measure, which is something to be aware of.

Bank (insurance) guarantee will secure recourse

Therefore, a bank or insurance guarantee will be a more effective instrument to recover sums paid to subcontractors. In addition to warranty or guarantee claims, it should also cover claims for the reimbursement of direct payments. The investor should ensure that the guarantee is unconditional, payable on

first demand, divisible, and concluded with a reputable entity, in an appropriate amount and duration. The contractor should be obliged to extend it and supplement it to the agreed amount if the investor draws on it before the end of its validity period.

The investor should have a right to draw on the guarantee as soon as the claim is made by the subcontractor, and not only after the claim has been paid. The investor may also secure the right to accept the terms of the guarantee in advance and to extend it at the contractor's expense if the contractor fails to perform its duty and does not ensure its continuity. A contractual penalty for not renewing the guarantee within a specified period may also help to mobilise the general contractor to extend the guarantee.

Ad hoc guarantee

A bank or insurance guarantee may also be useful when a subcontractor has filed a claim with the investor, but the investor cannot resolve the claim on the merits. This will be the case, for example, when the assessment of the claim requires special knowledge, or analysis of the complex problem of project delays. In such situations, general contractors often agree to provide a new bank guarantee to protect the investor against the particular subcontractor's claim, under pressure of suspending payments to the contractor. Such a guarantee should cover at least the aggregate amount of the principal claim with interest for a period of three years and the foreseeable litigation costs. The duration should be at least three years, i.e. at least equivalent to the limitation period of the subcontractor's claim. This solution ensures continuing liquidity of settlements with the general contractor and thus promotes the completion of the project. At the same time, it helps to pass on the risk of losing the court case to the subcontractor.

Agata Jóźwiak, attorney-at-law, Dispute Resolution & Arbitration practice, Wardyński & Partners

Settlements with subcontractors in public procurement

HANNA DRYNKORN

The Public Procurement Law provides for rules autonomous from the Civil Code for settlements with subcontractors. The regulations apply independently of each other, but they are applied in parallel to contracts concluded under the public procurement regime.

The rules for paying subcontractors in both of these acts are convergent in many respects, but the Public Procurement Law is more detailed. In many places, it regulates issues that in private contracts are the responsibility of the parties, benefiting the party that is better able to secure its interests contractually.

The circle of subcontractors

One of the basic problems of settling accounts with subcontractors under contracts not subject to the public procurement regime is to establish the set of subcontractors covered by the investor's joint and several liability, as the Civil Code does not resolve this issue and the case law is not uniform. More information on this subject can be found in the article "Is subcontracting easier? The effects of the amendment of Art. 647¹ of the Civil Code two years after adoption."

However, this problem does not occur in the case of settlements with public procurement subcontractors. The Public Procurement Law specifies that all subcontractors of construction works contracts should, as a rule, be treated equally. This was confirmed by the recent Supreme Court judgment of 20 September 2018 (IV CSK 457/11). The court pointed out that as a matter of principle, it would be unjustified to treat subcontractors of construction works contracts differently, because regardless of whether they perform construction works or services, or provide supplies, their works together constitute the subject matter of the contract. The court explained that the application of statutory protection under the Public Procurement Law depends on the subject matter of the agreement between the contracting authority and the contractor (award for public works), and not on the subject matter of subcontracting agreements. It boils down to a lack of differentiation in the situation of subcontractors regardless of what they perform under the main subject matter of the contract.

Direct payment mechanism

The Public Procurement Law also provides for a direct payment mechanism, which applies in private contracts only if the parties regulate it in the contract.

Pursuant to Art. 143c of the act, if a contractor, subcontractor or sub-subcontractor for public works fails to perform its obligation to pay, the contracting authority shall pay directly the entity that did not receive the due fee.

This provision applies to two groups of subcontractors and further subcontractors:

- Subcontractors with whom the contractor has concluded a contract for subcontractor works accepted by the contracting authority, whose subject matter is construction works
- Subcontractors of contracts whose subject matter is supplies or services.

A condition for including providers of supplies or services in the direct payment mechanism is that the subcontract has been submitted to the contracting authority. However, a contract for supplies or services does not have to be accepted by the contracting authority, as the act does not even provide for the procedure of acceptance of such types of contracts. But this provision does not apply to subcontractors whose existence the contracting authority has never learned about, which may apply for example to subcontractors of small-value contracts (below 0.5% of the value of the award) or subcontractors performing work within the scope for which the contracting authority indicated in the terms of reference that there is no obligation to submit supply or service contracts.

The provision on direct payments has raised considerable doubts in the case law. Until recently, it was commonly assumed that it resulted only in “the contracting authority’s right to make direct payment together with the obligation to exercise this competence.” With this approach, the subcontractor had no claim against the contracting authority for payment of the fee not paid by the contractor, even though the subcontractor was theoretically covered by the direct payment mechanism. The Supreme Court firmly rejected that position in the judgment of 20 September 2018 (IV CSK 457/11), indicating that Art. 143c of the Public Procurement Law is an independent legal basis for the contracting authority’s liability, and thus also covers, by virtue of the act, suppliers of materials and services, and consequently creates a claim on their part in this respect. The Supreme Court also stressed that this liability is joint and several liability. This finding was based on an amendment to the Public Procurement Law confirming the nature of the contracting authority’s liability (introduced by the Act of 7 April 2017 Amending Certain Acts to Facilitate Debt Recovery).

Procedure for payment of subcontractor’s fee

Before making a direct payment to subcontractors, the contracting authority must carry out a specific “investigation” into the legitimacy of their claims. In particular, it must give the contractor the opportunity to comment in writing on the legitimacy of such claims. The contracting authority will set a time limit of at least 7 days for submitting comments, and inform the contractor accordingly.

If the contractor submits comments, under Art. 143c(5) the contracting authority may find the subcontractor's claim to be justified or unjustified and make a direct payment or not accordingly. If there are fundamental doubts as to the amount of the payment due or the entity to which the payment is due, the contracting authority may also deposit the amount requested by the subcontractor with the court.

The act does not specify which documents should be presented by the subcontractor demonstrating its entitlement to receive direct payment from the contracting authority, or by the contractor contesting this claim. There is also no established case law in this respect. Therefore, the request for payment addressed to the contracting authority must be accompanied by as much documentation as possible to counterbalance any potential reservations on the part of the contractor. Evidence of proper performance of works and an invoice, for example, concerning the execution of the contract, should be provided.

Consequences of negligence in settling accounts with subcontractors

The Public Procurement Law provides for a number of possible actions by the contracting authority after direct payment to subcontractors. The most natural consequence of direct payment to the subcontractor will be setoff of the amount paid to the subcontractor from the contractor's fee, which is also applicable to contracts not subject to the public procurement regime.

However, the Public Procurement Law also provides for two additional sanctions that may be imposed on the contractor in such a case. First, the contracting authority has a statutory right to charge a contractual penalty (Art. 143d(1)(7)(a) of the Public Procurement Law). Another sanction is optional withdrawal from the contract by the contracting authority if it has to make multiple direct payments or payment of more than 5% of the value of the contract (Art. 143c(7)). In this case, the optional nature of the withdrawal means that exercise of the right of withdrawal lies within the discretion of the contracting authority. It may or may not be exercised in the event of specified misconduct on the part of the contractor in the settlement of accounts with subcontractors. However, withdrawal from the contract is possible only in the case of actual direct payment to the subcontractors, so it will not be applicable if the contracting authority deposits the relevant amount of money with the court,

Hanna Drynkorn, Infrastructure, Transport, Public Procurement & PPP practice, Wardynski & Partners

Between a rock and a hard place: General contractors squeezed by investors' joint and several liability regime

MACIEJ ZYCH

Since the introduction to the Civil Code and later the Public Procurement Law of provisions on the investor's joint and several liability for payments due to subcontractors of construction works, general contractors find themselves trapped between the need to supervise and discipline subcontractors and the pressure from the investor to pay them.

Only in Poland

Although construction companies operating in Poland for a longer time, both domestic and foreign, have grown accustomed to this mechanism, it is worth mentioning by way of introduction that the investor's joint and several liability to subcontractors (Art. 6471 of the Civil Code and Art. 143c of the Public Procurement Law) appears to be a solution unique to the Polish legal system; similar solutions are rare in other countries. Among foreign investors or contractors just entering the Polish market, it causes at least surprise or even shock.

No wonder then that there are (although less and less frequently) attempts to exclude this regime, among other things by choosing foreign law for (sub)contracting agreements. However, as a rule, they are doomed to fail. The provisions on joint and several liability are absolutely binding, and from the perspective of private international law they would most likely be considered mandatory provisions, binding independently of the law governing the contract.

Do the provisions really protect subcontractors?

Such (formally) strong protection of subcontractors by the parliament is no coincidence. The provisions on joint and several liability were introduced into Polish law at a time when, unfortunately, the Polish construction sector was experiencing a recurrent cyclical crisis, in order to prevent a wave of subcontractors' bankruptcies due to payment gridlock on the part of general contractors and sometimes their own bankruptcies.

However, despite the declared objective, the provisions on the investor's joint and several liability often play a different role in reality, as leverage in negotiations with the general contractor or a way to bypass the general con-

tractor in payments. Thus they reduce the effectiveness of the tools for discipline and supervision available to the general contractor, such as charging contractual penalties or withholding payments. Nor can this rather incidental effect of the regulation be regarded as entirely negative, as it balances in a certain sense the positions of subcontractors and general contractors. And sometimes the investor's joint and several liability does fulfil its intended function of protection against insolvency. This is the case with the increasingly frequent abandonment of construction sites by the general contractor without paying the subcontractors, and in the case of bankruptcy.

What is the general contractor afraid of?

In the absence of statistics, it is difficult to speculate which function this rule performs more often in practice. However, from the perspective of the general contractor, the spectre of joint and several liability is above all a threat that must be avoided—and this has not been changed by the latest amendment to Art. 647¹ of the Civil Code.

The existence of the investor's joint and several liability can place the general contractor between a rock and a hard place. On one hand, it must seek declarations of no arrears from the subcontractor in order to obtain full payment itself from the investor, but on the other hand, it has an interest in supervising and disciplining the subcontractors, even if only to avoid the investor's objections as to the time and quality of executed works. It is often impossible to reconcile these contradictory considerations.

During contract performance, it is in the interest of the general contractor to ensure, first and foremost, that no fee is paid to a subcontractor for work whose quality is disputed, and that the payment is not made in avoidance of the general contractor's counterclaims against the subcontractor in question. Direct payment does not deprive the general contractor of its claims against the subcontractor, but it does make it difficult to enforce them.

Consequences difficult to overturn

It is worth analysing the consequences of a sample worst-case scenario, where the general contractor first deducts its claim, e.g. for a contractual penalty, from the subcontractor's claim for payment, and yet the entire tranche payment, not reduced by the setoff, is paid to the subcontractor by the investor. Regardless of the investor's motives (such as a lack of awareness, a different assessment of the situation, relations with participants in the construction process), this situation raises several questions.

First of all, can the general contractor in such a situation demand payment of the full fee from the investor?

If only in reality the setoff was ineffective, i.e. the investor made a mistake in making a direct payment, then in legal terms the general contractor retains its claim for payment of its entire fee. An effective setoff is legally equivalent to a payment—in a sense it is a specific form of payment, where the counterclaim is the “settlement currency.” Thus, if the general contractor makes a valid setoff, the subcontractor is satisfied in that part and the investor is relieved of that liability. A direct payment by the investor in such a situation is an independent payment which does not give rise to any recourse by the investor against the general contractor and therefore cannot lead to a reduction of the payment due the general contractor.

The general contractor could successfully pursue its case in court, especially as it would have a very favourable distribution of the burden of proof. It would only have to prove that work has been done for which payment is due, which should be undisputed if the investor paid the subcontractor for it. On the other hand, the investor would bear the difficult burden of proving from its standpoint that the contractual penalty imposed by the general contractor was unjustified or the setoff was invalid for formal reasons.

However, the question is whether it is possible to avoid a time-consuming court case, e.g. by setting off the same receivable from the next tranche of the subcontractor’s fee, hoping that this time the investor can be persuaded to see it the general contractor’s way—if only because more evidence has been collected or because the investor has learned from the mistake resulting from its lack of awareness.

Unfortunately, the answer is no, which follows from the earlier comments. Since the setoff was an effective payment, it also led to the cancellation of claims for a contractual penalty. Setting it off again would be like a second demand for payment of the same amount. What is worse, it is not possible to set off the overpayment claim, i.e. for unjust enrichment, because in such situation, it is only the investor who is entitled to that claim.

So what else can be done? If the general contractor has a (very) good relationship with the investor, it can, for example, persuade it to assign the overpayment refund claim, which can then be applied when paying the next tranche to the subcontractor, by way of setoff.

It should be noted by the way that when considering mutual settlements between the general contractor, subcontractors and the investor, the exact sequence of events is crucial. If the only detail different in the above scenario is that the setoff of the contractual penalty by the general contractor took place after the direct payment by the investor, the general contractor would have retained the right to demand payment of the penalty from the

subcontractor, but it would probably have no claim for payment from the investor—assuming that the investor itself had made an effective setoff of the recourse claim in the amount of the direct payment made.

An ounce of prevention

However, it is best to avoid direct payment by the investor for the subcontractor's contentious claims as much as possible.

At the stage of concluding the contract with the investor, the general contractor should ensure an absolute right to address any request for direct payment, and an obligation on the investor's part to inform the general contractor of the subcontractor's claims before payment is made. In practice, investors usually take care of this themselves, as it is in their own interest, but it should be secured by a contractual provision.

If the subcontractor's contractual penalties have to be set off during the implementation phase, the general contractor should carefully record the evidence of entitlement to the penalties and ensure that the allegations against the subcontractor are clearly set out in the official correspondence, preferably before it makes a direct claim. All this is necessary to avoid undermining the credibility of the general contractor's claims in the eyes of the investor, and in the long term, in the eyes of the court.

It is also important that the claims to be set off are properly selected. If the general contractor wants to stop a possible direct payment, it should invoke easiest verifiable claims. Usually, a contractual penalty for delay in a strict sense, i.e. independent of fault, is the most reliable tool. At the opposite end of the spectrum are claims based on quality issues, i.e. defects in the work performed. To ensure that such a request does not raise any doubts on the part of the investor, it is advisable to commission an independent technical expert's report, which will not replace the later opinion of a court-appointed expert but must suffice at the stage of contract performance. The weakest instruments for stopping direct payments are claims not related to the project, due to the investor's lack of knowledge on the subject and lack of an interest in disciplining the subcontractor in this respect.

Will something change?

There is no indication that, apart from revisions such as those introduced by the 2017 amendment, the mechanism of joint and several liability of the investor will undergo serious changes, not to mention disappear from Polish law. For this reason, participants in the construction process—including general contractors, who have been put in a difficult situation—have to adapt to the situation so they can consciously and effectively limit the associated risks.

Maciej Zych, adwokat, Dispute Resolution & Arbitration practice, Wardynski & Partners

Construction contracts

We draft and advise on construction contracts, subcontracts, design contracts, and agreements for design supervision, investor supervision, and contract engineer services. For banks, we also review contracts for construction works to identify financial risks (e.g. agreements with general contractors or contract engineers).

We provide legal assistance in negotiation of contract conditions between the parties and with financial institutions, including work aimed at optimising contractual solutions.

We advise on appointment of contractors for construction work and preparation of proceedings for award of contracts for construction work under the public procurement regime, as well as verifying bids by contractors.

We also provide comprehensive legal advice connected with management of construction contracts and ongoing legal support during construction, including legal analysis of circumstances affecting the liability of participants in the development process. We support contractors and investors in administrative proceedings during the construction process, including procedures for obtaining administrative permits and decisions. We take part in negotiations with NGOs involving possible environmental impacts of development projects.

We advise contractors and investors on assertion and review of claims arising during contract performance. We offer a full range of legal support in disputes between parties to construction contracts and disputes with the contract engineer. We represent parties before dispute adjudication boards, arbitral tribunals and state courts in construction matters, with a particular focus on disputes arising under FIDIC contract conditions.

Wardyński & Partners

Al. Ujazdowskie 10, 00-478 Warsaw

Tel.: +48 22 437 82 00, 22 537 82 00

Fax: +48 22 437 82 01, 22 537 82 01

E-mail: warsaw@wardynski.com.pl

