

Joint Checks

Where and How Joint Check Arrangements Can Go Awry



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I. Joint Check Arrangements



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Joint Check Arrangements

JOINT CHECK ARRANGEMENTS TO LOWER TIER SUBCONTRACTORS & SUPPLIERS

Too often, despite having already paid for completed work, a contractor learns that its payments were pocketed by a first tier subcontractor, leaving the lower tier subcontractors and suppliers unpaid. By the time lien and/or payment bond claims are filed the contractor may have little to no contract funds remaining under the subcontract available to offset those claims, thereby resulting in the contractor paying for the work of those lower tiers again. No one wants to pay twice for the same goods or services.

In an attempt to avoid this risk, the contractor may issue joint check payments as allowed under the subcontract or enter into formal joint check agreements with its subcontractors and the subcontractors' vendors. Unfortunately, for the reasons discussed below, payments by joint check do not always insulate the contractor from having to pay twice. A joint check arrangement can take many forms, ranging from the issuance of a check payable to two or more parties as co-payees ("joint checks"), to a formalized detailed agreement between the contractor, subcontractor and their lower tier subcontractors and suppliers ("joint check agreements").

Joint Checks

While it may be enticing for a contractor to take the easier route of merely issuing a joint check, depending on several factors including the state and the project type (private vs public) and contract terms, such action may fall short of protecting the contractor from paying twice. For instance, if the subcontract does not have a provision that authorizes the contractor to issue joint checks, then unilaterally issuing a joint check may be a breach of the subcontract. Also, consider that if the joint check is deposited without the proper endorsements, the contractor (and its surety) could still retain liability and thus have to "pay twice." Some states have adopted a **"Joint Check Rule"** which may protect contractors trying to mitigate the risk from having to pay twice.

For specific information on a state-by-state basis as to which states have adopted the **Joint Check Rule**, please ask your agent or underwriter for Travelers' State-by-State Survey on Joint Check Arrangements

The most advantageous approach to the contractor and its surety issuing joint checks are those jurisdictions that follow the "California Rule" or "Joint Check Rule".¹ Under the California Rule, the contractor's issuance of a joint check discharges both the contractor and its surety from liability to lower tier contractors/suppliers. Absent an allocation of the payment to specific invoices or amounts, the lower tier subcontractor's/supplier's endorsement of a joint check presumes that it received all money due, even if only some (or no) funds were actually received. Joint check endorsement also presumes a release of lien rights. Under the California Rule then, because a surety is entitled to assert its principal's (the contractor's) defenses, the presumption of full payment and release of lien rights will preclude lower tier subcontractors/suppliers from recovering against the surety's payment bond.

The Joint Check Rule's object is to generally provide owners and general contractors a means to protect themselves from unpaid subcontractors/suppliers by recognizing that the issuance of joint checks empowers those same subcontractors/suppliers to withhold their endorsement until satisfactorily securing payment (e.g., receive payment prior to endorsing the check, enter into a formal escrow arrangement). However, it is not uniformly applied

and there is no easy way to distinguish the numerous variations of how jurisdictions that recognize the Joint Check Rule apply it to specific case circumstances (i.e., not applicable to surety, not the full amount of the joint check, etc.).²

In some jurisdictions the Joint Check Rule applies to both private and public (non-federal) projects, whereas others limit the rule to only private projects. Also, some jurisdictions presume that the full joint check amount has been paid, whereas others restrict and/or disavow that presumption and instead look to a specific payment allocation between the co-payees (e.g., specific dollar amount, invoice number and/or separate agreement). For example, California, Iowa, Louisiana, Missouri, South Carolina, Texas and Washington are among the jurisdictions that follow the Joint Check Rule for the benefit of both the contractor and its surety. Jurisdictions such as Arizona, Arkansas, Nevada, Oklahoma and Utah, however, are unclear or silent as to whether the Joint Check Rule extends to the surety, while Maryland and Ohio specifically do not extend it to the surety. California, Montana and Oklahoma recognize endorsement of a joint check as an effective waiver of a subcontractor/supplier's lien rights. However, Alabama, Colorado, Connecticut, Idaho, Indiana, Kansas, Massachusetts, Michigan, Minnesota and South Dakota require additional circumstances for an effective waiver to exist. On the other hand, Arizona, Arkansas and Oregon do not recognize a waiver, while Delaware and Maryland find any such waiver void and unenforceable.

Unfortunately, over half the jurisdictions are silent regarding the impact of joint checks or specifically reject the Joint Check Rule. In those jurisdictions, a joint check endorsement alone has an unknown impact on the contractor's payment obligations and waiver of statutory lien rights, thereby leaving the contractor and/or its surety exposed to potential further liability for non-payment. In those jurisdictions it would be best to consult with a construction lawyer to advise what can and cannot be done to protect the contractor's and surety's interests.

Where the Miller Act is applicable, the contractor must pay special attention because the Joint Check Rule does not apply. Federal

courts addressing the issue view such arrangements as a request for added security, as the rights under the Miller Act are found not to impose a specific legal obligation to deduct amounts from a joint check. Therefore, endorsement of a joint check alone will not release or waive a subcontractor/supplier's Miller Act rights.³ Under certain circumstances, including the use of a specific Joint Check Agreement, a contractor may be able to issue joint checks on Miller Act projects to limit its liability. Generally, if the specific Joint Check Agreement expressly states that a joint payee's endorsement shall be deemed payment in full, then such endorsement can result in a release and/or waiver being found.

Joint Check Agreements

Instead of issuing joint checks, a contractor could put a Joint Check Agreement – a tri-party agreement with the contractor, subcontractor, and lower tier(s) – in place which spells out the respective rights of the parties regarding issuance, endorsement, and the effect of joint check payments. Among other things, a formal Joint Check Agreement avoids later factual disputes based on the intention of the parties. However, care should be taken before entering into a Joint Check Agreement because a poorly crafted one could actually expand the contractor's liability. For example, it must be drafted to avoid creating an independent payment obligation on the part of the contractor and/or negating its available statutory and/or contractual protections (e.g., strict adherence to timely notice and/or direct contractual relationship requirements). It is for these reasons that seeking competent legal counsel is recommended to determine the enforceability and benefits of a Joint Check Agreement.

Regardless of which approach is contemplated – Joint Checks or Joint Check Agreements – contractors should be aware of the pitfalls associated with these approaches and consult with knowledgeable construction counsel.

When properly used joint check arrangements are a powerful form of payment in a contractor's toolbox that can protect it and its surety against paying twice for labor and materials. However, even though joint checks have a long standing record of use in the construction industry depending on the State, the project type and other factors, their effectiveness will vary greatly. Careful consideration and legal consultation should be taken to fully understand the Joint Check Rule's applicability before issuing such payments.

¹ See Post Bros. Constr. Co. v. Yoder, 20 Cal.3d 1, 3, 141 Cal Rptr. 28, 30, 569 P.2d 133, 135 (1977).

² See, Travelers, 50 State Survey, State-by-State Survey on Joint Check Arrangements (Aug. 2012).

³ See, e.g., Friedrich Refrigerators, Inc. v. Forrester, 441 F.2d 779 (5th Cir. 1971); Clark-Fontana Paint Co. v. Glassman Const. Co., 397 F.2d 8 (4th Cir. 1968); Koppers Co. v. Five Boro Const. Corp., 310 F.2d 701 (4th Cir. 1962)



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II. Joint Checks Agreements: Key Points In Drafting And Pitfalls To Keep In Mind



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Joint Checks Agreements: Key points in drafting and pitfalls to keep in mind

Zero Regulation: Anything can go...

Joint check agreements have no regulation. There is no such thing as a “standard” joint check agreement. You do not know what rights it gives you (or rights it limits/takes away, or obligations it places on you...) until you see it.

So how should you draft? Key provisions in the Joint Check Agreement to keep in mind:

Joint checks can be a good tool to facilitate distribution of project funds to the intended recipient, thereby helping the project to keep moving. They also protect a General Contractor from paying twice. However, because of the legal ramifications, they should only be used with an agreement covering the following points:

- Identification of all three parties;
- Identification of the particular project and a clear statement that the arrangement is limited to that project;
- Maximum amount paid or to be paid;
- A provision that appropriate lien waivers will be issued in exchange for the payment;
- No continuing duty to issue joint checks except as expressly covered by the agreement;
- Agreement made solely as a convenience;
- Agreement does not create any contractual rights in creditor/lower tier subcontractor and General Contractor.

Be Cautious:

Joint check agreements may also arise when a supplier refuses to supply materials to a subcontractor unless the subcontractor and the general contractor agree that the general contractor will pay by joint check. Usually in those situations, the supplier proposes a form of joint check agreement. General contractors must read such forms with caution since suppliers often include other obligations in such forms (e.g., the form may say that the general contractor will issue joint checks *and* guarantee payment to the supplier). Most additional obligations will be enforced by the courts. If a general contractor is willing to issue joint checks, it should be sure that the joint check agreement proposed does not have additional obligations that it is unwilling to accept.

Things to be wary of regarding joint checks:

- read anything that you’re supposed to sign thoroughly;

- put measures in place to avoid forgeries;
- Execute a joint check agreement prior to commencement of work

Key provisions to have in your Subcontract Agreement

General contractors often include a provision in their subcontracts that gives them the right to issue joint checks (e.g., "Contractor may, but is not obligated to, issue joint checks to Subcontractor and any of its suppliers."). Such provisions are an important risk-management tool, but must be drafted carefully. The prime contractor must obtain the consent of its subcontractor before making joint payments. The best practice is to address this issue up front with express language in the subcontract giving the prime contractor the right, but not the obligation, to issue joint checks if necessary. Absent express authorization in the subcontract to issue joint checks, the prime contractor cannot relieve itself of its payment obligations to the subcontractor by unilaterally issuing joint checks and will still be responsible for ensuring that its subcontractor is paid in full regardless of whether the supplier is paid.

Make clear that the right to issue joint checks does not create a duty to issue joint checks. If a general contractor *agrees* to issue joint checks to the subcontractor and its supplier (a mandatory obligation as opposed to just having the right to do so), the supplier may enforce the agreement against the general contractor.

For example, assume a supplier requires a subcontractor to get the general contractor to agree to issue joint checks and the subcontractor proposes the following modification to the subcontract: "Contractor *shall* issue joint checks to Subcontractor and its material supplier." If the general contractor accepts the change but neglects to issue joint checks, the supplier will be able to sue the general contractor for breach of contract if the supplier is not paid. The supplier is entitled to rely on the subcontractor's subcontract with the general contractor if the language requiring the general contractor to issue joint checks is mandatory.

Consider including a form joint check agreement as an exhibit to the subcontract and making the subcontractor's failure to execute the joint check agreement as to any supplier or lower-tier subcontractor a basis for withholding progress payments to the subcontractor.

Delivery of the Joint Check

A general contractor should also require the debtor to come to the general contractor's office to endorse the joint check and then the general contractor should deliver that check to the creditor. This eliminates any risk of forgery on the check and makes sure the check is actually delivered

III. Treatment of Joint Checks in Bankruptcy



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Treatment of Joint Checks in Bankruptcy

Introduction

General contractors, first tier subcontractors, and lower tier suppliers and subcontractors (and, on occasion, owners) for reasons specific to a project or the creditworthiness of an intermediate party, participate in joint check arrangements. The critical common element in all joint check arrangements, whether done by three party written agreement or course of conduct, is the issuance, typically by the general contractor, of a check made jointly payable to a first tier subcontractor and a lower tier supplier or subcontractor. The general contractor's purpose in issuing a joint check is to satisfy its contractual payment obligation to its subcontractor and, at the same time, cause its subcontractor to satisfy its payment obligation to its lower tier supplier or subcontractor. By participating in a joint check arrangement, the general contractor may facilitate continuity of work and a project's progress and avoid work stoppages, project liens and bond claims.

The enforceability of joint check arrangements generally and within bankruptcy is highly fact specific and varies by jurisdiction.¹

Within a bankruptcy case, disputes involving joint checks typically arise in the following contexts: (i) litigation over the relative rights of a lower tier subcontractor and a first tier subcontractor's bankruptcy trustee or secured creditor to receive or retain a joint check after a subcontractor files for bankruptcy or (ii) litigation brought by a subcontractor's bankruptcy trustee to recover payments received by a lower tier subcontractor via joint check during the ninety (90) day preference period prior to a subcontractor's bankruptcy filing. As discussed below, in both contexts, the resolution of the dispute largely turns on the determination of the subcontractor's property interest, or lack thereof, in a particular joint check as a matter of state law or on whether the general contractor had an independent obligation to pay the lower tier subcontractor.

Bankruptcy Law

Is a Joint Check Included within or Excluded from Property of the Bankruptcy Estate?

The filing of a bankruptcy petition creates an estate consisting of "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." 11 U.S.C. § 541(a)(1). The scope of property of the bankruptcy estate is intentionally broad and includes all property "wherever located and by whomever held." 11 U.S.C. § 541(a). However, "[p]roperty in

¹ See generally "Joint Check Arrangements" by The Travelers Indemnity Company and "Joint Check Agreements: Key Points in Drafting and Pitfalls to Keep in Mind" by Kimberly Gessner.

which the debtor holds . . . only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title . . . but not to the extent of any equitable interest in such property the debtor does not hold.” 11 U.S.C. § 541(d). The estate does not take a greater right or interest in property than the debtor had. *See* Senate Rep. No. 989, 95th Cong., 2d Sess. 82, U.S. Code Cong. & Ad. News, 5787, 5868.

In *Mid-Atlantic Supply, Inc. of Virginia v. Three Rivers Aluminum Co.*, the Fourth Circuit thoroughly examined the legislative history of § 541, prior case law, and the many facts and circumstances that influence whether a joint check is included within or excluded from a bankruptcy estate. 790 F.2d 1121, 1124 (4th Cir. 1986). A review of the *Mid-Atlantic* case should be the starting point in any bankruptcy litigation involving property of the estate, joint checks or express or constructive trusts. The case is also a textbook guide for how best to structure a joint check arrangement to enhance the likelihood that the arrangement will be enforced in a subsequent bankruptcy.

In *Mid-Atlantic* the Fourth Circuit considered the relative rights of a lower tier supplier and a subcontractor's secured creditor (whose rights were derivative of the subcontractor's rights) to a joint check issued by a general contractor to the subcontractor and the supplier. The Court held that the joint check, which was in the possession of the subcontractor, was impressed with a constructive trust for the benefit of the supplier as a matter of the applicable state law (here, Virginia). *Id.* at 1124–27. Since the check was held in trust, it was excluded from the subcontractor's bankruptcy estate and turned over to the lower tier supplier. And since the joint check was not property of the bankruptcy, the security interest of the subcontractor's lender in accounts receivable did not attach to the joint check. *Id.* at 1128.

In reaching its holding in *Mid-Atlantic* the Court emphasized the following facts: the supplier refused to do business with the subcontractor on credit; the supplier, as a condition of accepting the subcontractor's purchase order to manufacture custom windows, required an agreement with the general contractor and subcontractor that it would be paid by joint check issued by the general contractor and supported by the credit of the general contractor; the parties agreed that the joint check to the supplier would pay for the windows delivered by the supplier and not the window installation services of the subcontractor, which would be separately paid. The Court held that the subcontractor was a “mere conduit” for the payment from the general contractor to the supplier. *Id.* at 1127. In support of its imposition of a constructive trust on the joint check for the supplier, the Court further held that the supplier's reliance on payment from the general contractor before it undertook to manufacture and deliver the windows estopped the general contractor and the subcontractor from revoking the joint check agreement. *Id.*

Notably, the Court also re-stated the general rule that once an express,

statutory, or constructive trust is established over property in the possession of a bankruptcy trustee or chapter 11 debtor-in-possession, the “sole permissible administrative act” of the trustee or debtor-in-possession is “to pay over or endorse over the property to the beneficiary . . . of the trust.” *Id.* at 1126.

In *Georgia Pacific Corp. v. Sigma Service Corp.*, a case which involved similar issues but materially different facts from those in *Mid-Atlantic*, the Fifth Circuit held that the joint checks at issue were property of the bankruptcy estate. 712 F.2d 962 (5th Cir. 1983). In *Sigma*, a general contractor unilaterally requested that a project owner pay it and its suppliers by joint checks. Unlike in *Mid-Atlantic*, the parties did not execute a joint check agreement or otherwise discuss or agree to terms. Nevertheless, the project owner delivered joint checks to the general contractor payable to it and certain suppliers. Unlike in *Mid-Atlantic*, in *Sigma* there was no record evidence that the suppliers required joint checks to perform or relied on a joint check arrangement.

In *Sigma*, the general contractor did not endorse the joint checks the owner delivered to it. Instead, the general contractor asked the owner to re-issue the checks to it alone as the sole payee. The owner declined. The general contractor then filed for bankruptcy and, as a chapter 11 debtor-in-possession, filed a lawsuit to compel the owner to pay it the joint check amounts. The suppliers intervened in the lawsuit and sought to impose a constructive trust or statutory trust on the joint checks as a matter of applicable state law (here, Arkansas and Mississippi).

The Fifth Circuit found that the general contractor’s joint check request was revocable (unlike in *Mid-Atlantic*) since there was no record evidence of supplier reliance. Not surprisingly, the Court held that the issuance of joint checks alone is not grounds for imposition of a constructive trust. Finally, in light of the record and applicable state law, the Court found it could not impose a constructive trust or a statutory trust on the joint checks for the benefit of the suppliers, and held that the joint checks were property of the bankruptcy estate.

As discussed above, specific facts and circumstances influence whether or not a joint check is administered as property of a bankruptcy estate. The closer the facts are to those in the *Mid-Atlantic* case, and the more the facts and the applicable state law support impressing an express, constructive, or statutory trust on a joint check, the more likely it is that a joint check will be excluded from property of the estate and turned over to its equitable owner. Conversely, the closer the facts are to those in the *Sigma* case, and the less indicia of trusts there are, the more likely it is that a joint check will be administered within a bankruptcy case.

Is a Payment by a Joint Check a Transfer of an Interest of the Debtor in Property under the Preference Statute?

Bankruptcy law and policy favor equality of distribution among similarly situated creditors. *Begier v. I.R.S.*, 110 S. Ct. 2258 (1990). To that end, and to discourage favoring one creditor over another during insolvency and the slide into bankruptcy, bankruptcy law allows a bankruptcy trustee to avoid and recover for the bankruptcy estate certain payments made prior to the filing of a bankruptcy case. *Id.*; 11 U.S.C. §§ 547, 550.

The threshold element of a preference cause of action is that the transfer was of “an interest of the debtor in property.”² If the property transferred was not the debtor’s property, or property in which the debtor had an interest, the preference cause of action fails. *See e.g., Begier* (transfer of tax trust funds was not a transfer of the debtor’s property); *Wolff v. U.S. (In re FirstPay, Inc.)*, 773 F.3d 583 (4 th Cir. 2014).

This gate-keeping element of a preference cause of action has been litigated in numerous construction industry bankruptcy cases involving payments by joint check. Nevertheless, as one court remarked recently, the law in this area remains unsettled. *Davis v. Kice Industries, Inc. (In re WB Services, LLC)*, 587 B.R. 548 (Bankr. D. Kan. 2018).

Many courts have found that the co-payee (later debtor) of a joint check had a sufficient property interest in the joint check to satisfy this element of a preference cause of action, reasoning that the co-payee’s relinquishment of the right to receive a payment was a transfer of its property interest. *See Code Electric, Inc. v. Crampton*, 197 B.R. 807 (D. N.C. 1996); *Kice, supra*; *Napolitano v. Vibra-Conn, Inc. (In re Patton Co.)*, 348 B.R. 618 (Bankr. D. Conn. 2006). These courts have considered but been unpersuaded by the argument that the joint check issuer had an independent obligation to the lower tier co-payee such that the transfer was a transfer of its own property, not the debtor’s property. *Supra*.

² The bankruptcy preference statute provides, in pertinent part, that a trustee may avoid **any transfer of an interest of the debtor in property**-[emphasis added]

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under Chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b).

See also Dal-Tile Corp. v. Reitmeyer (In re Buono), 119 B.R. 498 (Bankr. W.D. Pa. 1990) (considering and rejecting argument that a constructive trust was imposed on joint check payment; noting that a joint check agreement entered into before the 90 day preference period may protect a transfer within the preference period.).

On the other hand, in *Steelvest, Inc. v. Messer and Sons Construction Co. (In re Steelvest, Inc.)*, the bankruptcy court found that a three way joint check agreement divested the debtor of its interest in property and, alternatively, that the joint check agreement imposed an independent obligation on the general contractor to pay the lower tier subcontractor, insulating the payment from avoidance. 112 B.R. 852 (Bankr. W.D. Ky. 1990). *See also, McShane, Inc. v. Monumental Supply Co. (In re McShane, Inc.)* 328 B.R. 430 (Bankr. D. Md. 2005) (creative use of three way settlement agreement).

As discussed above, the outcome of preference litigation involving joint checks is difficult to predict. However, a well drafted joint check agreement entered into prior to the 90 day preference period or at the onset of the contract, and some degree of independent obligation, may prove to be defenses to a preference claim.

Finally, bear in mind that there are several other elements a trustee must establish to recover a preferential transfer and statutory defenses under the preference statute that would likely be applicable.

Conclusion

Caution and attention to details are advisable in any joint check arrangement. The timing of entering into the arrangement and the details of the agreement will influence how the arrangement is viewed in a subsequent bankruptcy.