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**PAYMENT PROVISIONS IN CONSTRUCTION CONTRACTS  
AND CONSTRUCTION TRUST FUND STATUTES: A FIFTY  
STATE SURVEY**

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# PAYMENT PROVISIONS IN CONSTRUCTION CONTRACTS AND CONSTRUCTION TRUST FUND STATUTES: A FIFTY STATE SURVEY

## I. INTRODUCTION

This article surveys the law on the enforceability of the common construction contract provisions referred to as “pay-when-paid” and “pay-if-paid” provisions in each of the 50 states and the District of Columbia. This article also surveys the law on the statutory trusts enacted by some state legislatures regarding payments on construction projects, which statutes are commonly referred to as construction trust fund statutes. We asked our contributors to summarize the current state of the law on “pay-when paid” clauses separately from “pay-if-paid” clauses, as many courts treat the two differently. We further asked our contributors to describe any differences in the enforceability of such clauses in general contracts and in subcontracts and on public projects and on private projects. For states with construction trust fund statutes, we asked our contributors to address the types of projects to which the statute applies, the parties to whom the statute applies, the funds to which the trust attaches, the remedies available for violations of the trust, and whether the trustee is entitled to commingle the trust funds. Our original intent had been to develop a matrix, but as the reader will see the answers to these questions do not lend themselves to small boxes. We appreciate the efforts of the many contributors from around our great country who were willing to research and summarize the current law in their respective jurisdiction. The summaries are intended to be exactly that; they do not purport to address every nuance of the law or every possible fact pattern. Consultation with knowledgeable local counsel is, of course, advisable to understand the application of these general principles to any particular real life situation.

## II. “PAY-WHEN-PAID” AND “PAY-IF-PAID” PROVISIONS

Parties are generally free to negotiate the terms of their contracts, and are generally permitted to negotiate and allocate the risks under their contracts, including the risk of non-payment. Many courts take a strict view of contracts.<sup>1</sup> They see contracts as private law making and will not revise the terms of the contract to achieve “equity.”<sup>2</sup> Other courts strictly construe risk shifting provisions that result in harsh outcomes for contracting party that is viewed as less capable of assuming the shifted risk.<sup>3</sup> Those courts may find such provisions void as against public policy.<sup>4</sup> Some state legislatures have enacted laws prohibiting provisions in contracts shifting the risk of non-payment.<sup>5</sup> Alternative dispute resolution providers also address those clauses. The growing view of the industry is that

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<sup>1</sup> See generally, *Berkel & Co. v. Christmas Co.*, 533 N.W.2d 838 (Mich. Ct. App. 1995).

<sup>2</sup> See *id.*

<sup>3</sup> See *Capitol Steel Fabricators, Inc. v. Mega Constr. Co., Inc.* 58 Cal. App. 4<sup>th</sup> 1049 (1997); *William R. Clarke Corp. v. Safeco Ins. Co.*, 938 P.2d 372 (Cal. 1997).

<sup>4</sup> See *id.*

<sup>5</sup> See N.C. Gen. Stat. § 22C-2 (2003); Wis. Stat § 779.135(3) (2003).

condition precedent clauses of all sorts are easily overcome in alternative dispute resolution, leading many owners or general contractors to abandon arbitration clauses altogether.<sup>6</sup>

While the terms “pay-when-paid” and “pay-if-paid” are commonly used in the construction industry and are distinct clauses, commentators and courts have not universally applied these terms in discussing such provisions. Some courts refer to both provisions as “pay-when-paid” provisions and simply differentiate between those “pay-when-paid” provisions that act as reasonable timing provisions from those that act as conditions precedent. Therefore, it is critical to examine the actual contractual provision at issue in a case to determine the court’s actual holding – do not rely on the characterization of the clause in the opinion.

A typical “pay-when-paid” clause might read: “Contractor shall pay subcontractor within seven days of contractor’s receipt of payment from the owner.” Under a “pay-when-paid” provision in a construction subcontract, a contractor’s obligation to pay the subcontractor is triggered upon receipt of payment from the owner.<sup>7</sup> Most courts hold that such a clause means that the contractor’s obligation to make payment is suspended for a reasonable amount of time for the contractor to receive payment from the owner.<sup>8</sup> The theory is that a “pay-when-paid” clause creates a timing mechanism only. Such a clause does not create a condition precedent to the obligation to make payment and does not expressly shift the risk of the owner’s nonpayment to the subcontractor. We have seen no jurisdiction that treats a pure “pay-when-paid” clause as a condition precedent to payment. We saw no trends indicating a difference in the enforcement of “pay-when-paid” clauses on private projects as opposed to public projects or at different tiers of contractors.

A typical “pay-if-paid” clause might read: “Contractor’s receipt of payment from the owner is a condition precedent to contractor’s obligation to make payment to the subcontractor; the subcontractor expressly assumes the risk of the owner’s non-payment and the subcontract price includes this risk.” Under a “pay-if-paid” provision in a construction contract, receipt of payment by the contractor from the owner is an express condition precedent to the contractor’s obligation to pay the subcontractor. A “pay-if-paid” provision in a construction subcontract shifts the risk of the owner’s non-payment under the subcontract from the contractor to the subcontractor.<sup>9</sup> In many jurisdictions, courts will

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<sup>6</sup> There are other reasons for this trend, including the rising cost of arbitration, the increased willingness of arbitrators to grant broad discovery, the increased time to resolution, and the lack of appeal rights.

<sup>7</sup> See, e.g., *Seal Tite Corp. v. Ehret, Inc.*, 589 F. Supp. 701, 703-05 (D.N.J. 1984); *Midland Eng’g Co. v. John A. Hall Constr. Co.*, 398 F. Supp. 981, 993-94 (N.D. Ind. 1975); *Peacock Constr. Co. v. Modern Air Conditioning*, 353 So.2d 840, 842 (Fla. 1990); *Southern States Masonry v. J.A. Jones Constr. Co.*, 507 So.2d 198, 201-06 (La. 1987).

<sup>8</sup> See *id.*

<sup>9</sup> See, e.g., *L. Harvey Concrete, Inc. v. Agro Constr. & Supply Co.*, 939 P.2d 811 (1997); *Main Elec., Ltd. v. Printz Servs. Corp.*, 980 P.2d 522, 527 (Colo. 1999).

enforce a “pay-if-paid” provision if the provision is clear and unequivocal.<sup>10</sup> Courts will generally find that a “pay-if-paid” provision does not create a condition precedent, but rather a reasonable timing provision, where the “pay-if-paid” provision is ambiguous.<sup>11</sup> Some courts have held that the use of the term “condition precedent” in a “pay-if-paid” provision is sufficient to render the clause enforceable as a condition precedent.<sup>12</sup> At least one court has held that inclusion of the term “condition precedent” is not dispositive, and that the language of the “pay-if-paid” provision must include unequivocal language indicating that the monies owed under the subcontract are only to be paid out of the construction funds that the contractor is to receive from the owner.<sup>13</sup>

At least two jurisdictions have held that “pay-if-paid” provisions are void as against public policy because such provisions violate the anti-waiver provisions in the states’ mechanic’s lien statutes.<sup>14</sup> While the “pay-if-paid” provisions involved in these cases did not expressly waive the subcontractors’ right to pursue a mechanic’s lien, the courts found that the “pay-if-paid” provisions effectively prevented the subcontractors from pursuing their mechanic’s lien rights in violation of public policy.<sup>15</sup> Under the statutes, the subcontractors’ mechanic’s lien rights are measured by the amounts due them under their subcontracts; therefore, if the “pay-if-paid” provisions were enforceable, the subcontractors would not have been due payment and could not pursue a remedy under the mechanic’s lien statutes.<sup>16</sup> Some other jurisdictions have legislatively rendered “pay-if-paid” clauses inapplicable to mechanic’s liens on the theory that if the owner is not paying the general contractor, the subcontractors should be entitled to pursue the owner directly.<sup>17</sup> Some states have legislatively prohibited conditional payment provisions all together.<sup>18</sup> Other states have legislatively restricted their application, for example to permit a subcontractor to

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<sup>10</sup> See, e.g., *North Market Ass’n v. Case*, 132 N.E.2d 122, 122-23 (Ohio Ct. App. 1995); *Gilbane Bldg. Co. v. Brisk Waterproofing Co.*, 86 Md. App. 21, 585 A.2d 248 (1991); *American Drilling v. City of Springfield*, 614 S.W.2d 266 (Mo. App. 1981).

<sup>11</sup> See, e.g., *Thos J. Dryer Co. v. Int’l Engineering Co.*, 303 F.2d 655 (6<sup>th</sup> Cir. 1962); *Main Elec., Ltd. v. Printz Servs. Corp.*, 980 P.2d 522 (Colo. 1999).

<sup>12</sup> See *Architectural Systems, Inc. v. Gilbane Bldg. Co.*, 760 F. Supp. 79 (D. Md. 1991); *Gilbane Bldg. Co. v. Brisk Waterproofing*, 86 Md. App. 21, 585 A.2d 248 (1991).

<sup>13</sup> See *L. Harvey Concrete, Inc. v. Agro Constr. & Supply Co.*, 189 Ariz. 178, 939 P.2d 811 (1997).

<sup>14</sup> See *William R. Clarke Corp. v. Safeco Ins. Co.*, 15 Cal. 4<sup>th</sup> 882, 64 Cal. Rptr.2d 578, 938 P.2d 372 (1997); *West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 638 N.Y.S.2d 394, 661 N.E.2d 967 (1995).

<sup>15</sup> See *id.*

<sup>16</sup> *Id.*

<sup>17</sup> See Mo. Rev. Stat. § 431.183 (2002); Colo. Rev. Stat. § 38-22-119 (2000); Ga.Code Ann. § 44-14-361.1(a)(4) (2003); Md. Real Prop. Code Ann. § 9-113(a) (1996).

<sup>18</sup> See N.C. Gen. Stat. § 22C-2 (2003); Wis. Stat. § 779.135(3) (2001).

pursue a bond claim or lien action.<sup>19</sup> We have seen no trends towards treating “pay-if-paid” clauses differently on public projects as opposed to private projects or at different tiers of contractors.

Parties attempting to utilize a “pay-if-paid” provision in a construction contract should be sure to research the applicable case law and statutes in their jurisdiction to determine whether such provisions are enforceable and whether there is any specific language that must be utilized in order for the provision to be deemed a condition precedent to payment. Likewise, parties presented with conditional payment provisions should be sure to research applicable case law and statutes to determine the risks that will be shifted to them as a result of such contractual language.

### III. CONSTRUCTION TRUST FUND STATUTES

Several states have enacted construction trust fund statutes in an attempt to ensure that subcontractors, and in some cases sub-subcontractors and suppliers, are paid monies owed to them for labor and/or materials supplied to construction projects.<sup>20</sup> A typical construction trust fund statute may provide as follows: “Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor, for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work or furnished materials, or both, for or about the building, for purposes of paying those subcontractors.”<sup>21</sup> Such a provision complies with all the necessary prerequisites for establishment of a trust under state law.<sup>22</sup> The trustee is the party who receives the monies. The trust property or *res* is the moneys paid for work done or materials furnished, or both, for or about the building. The trust beneficiaries are the subcontractors who did the work or furnished the materials. The purpose of the trust and the means by which the trustee can discharge its obligations are clearly identified; the purpose of the trust is to pay the trust beneficiaries.

Construction trust fund statutes attach a trust to funds paid or to be paid to contractors, and in some cases subcontractors, for the benefit of those supplying labor and/or material to a construction project.<sup>23</sup> Some construction trust fund statutes distinguish between public and private contracts and only apply to a specific class of project.<sup>24</sup> Other

<sup>19</sup> Md. Real Prop. Code Ann. § 9-113(a) (1996).

<sup>20</sup> See, e.g., Del Code Ann. tit. 6, § 3502 (2003); Minn Stat. Ann. § 514.02 (2002); Colo. Rev. Stat. Ann. § 38-22-1-27 (2000).

<sup>21</sup> See Md. Code Ann. Real Prop., § 9-201(b)(1) (1996 Repl. Vol.).

<sup>22</sup> See Restatement of the Laws 2d (Trusts), § 17.

<sup>23</sup> See e.g., Colo. Rev. Stat. Ann. § 38-22-127 (2000); Md. Code Ann. Real Prop., § 9-201 (1996 Repl. Vol.).

<sup>24</sup> See, e.g., Ariz. Rev. Stat. § 33-1005 (2003) (applies to owner occupied residential construction); Md. Real Prop. Code Ann. § 9-204(b)(1) (statute does not apply to residential construction); N.J. Stat. Ann. § 2A:44-148 (2000) (applies to public works); Wash. Rev. Code § 60.28.010 (2004) (applies to public improvements or works); S.D. Codified Laws § 44-9-3 (2004) (applies to construction trust funds in excess of \$500.00.)

constructive trust fund statutes apply only to claims that would be the proper subject of a mechanic's lien.<sup>25</sup> In such states, it follows that the statute would not apply on a public works project as such a project is not lienable.<sup>26</sup>

The various states' construction trust fund statutes vary widely with regard to the remedies provided under the statutes. Some states' statutes provide for civil remedies such as attorney's fees or interest if the construction trust funds are misappropriated.<sup>27</sup> Other states' statutes do not provide civil remedies for misappropriation of construction trust funds; instead these statutes provide solely criminal penalties in an attempt to deter misappropriation.<sup>28</sup> Some states construction trust fund statutes provide both criminal and civil penalties.<sup>29</sup> Construction trust fund statutes that provide criminal sanctions for misappropriation of trust funds generally only apply to funds already paid to a contractor.<sup>30</sup> The criminal trust fund statutes do not create private causes of action in favor of unpaid subcontractors.<sup>31</sup>

A few states provide for personal liability for officers or directors of the contractor if the trust funds are misappropriated.<sup>32</sup> This personal liability is usually only imposed on the officers or directors who controlled distribution of the trust funds.<sup>33</sup> The statute may require

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<sup>25</sup> See Colo. Rev. Stat. Ann. § 38-22-127 (2000); Okla. Stat. tit. 42, §§ 152-53 (2001).

<sup>26</sup> See Okla. Stat. tit. 42, §§ 152 and 153.

<sup>27</sup> See Ariz. Rev. Stat. § 33-1005 (2003) (interpreted to impose civil liability on corporate officers and directors that misappropriate funds in *Woodworking Enterprises, Inc. v. Baird*, 114 B.R. 198 (9<sup>th</sup> Cir. 1990); Colo. Rev. Stat. Ann. § 38-22-127 (2000) (interpreted as imposing civil liability upon officers controlling the disbursement of funds that divert funds in violation of the trust fund statute in *Flooring Design Assoc., Inc. v. Novick*, 923 P.2d 216, 221 (Colo. App. 1995); Wash. Rev. Code § 60.28.010 (2004) (imposes interest penalty upon owners); Minn. Stat. § 514.02 (2002) (providing for the recovery of attorney's fees).

<sup>28</sup> See Ga. Code Ann. § 16-8-15 (2003); S.C. Code Ann. § 29-7-10 (2003); S.D. Codified Laws § 44-9-13 (2004).

<sup>29</sup> See Del. Code Ann. tit. 6, §§ 3505-06 (2003); Mich. Comp. Law § 570.152 (1996); Minn. Stat. § 514.02 (2002).

<sup>30</sup> See generally, S.C. Code Ann. § 29-7-10 (2003); S.D. Codified Laws § 44-9-13 (2004).

<sup>31</sup> *Kayhoe Construction Corp. v. United Virginia Bank*, 220 Va. 285,257 S.E.2d 837 (1979); *Overstreet v. Commonwealth of Virginia*, 193 Va. 104, 67 S.E.2d 875 (1951).

<sup>32</sup> See *Woodworking Enterprises, Inc. v. Baird*, 114 B.R. 198 (9<sup>th</sup> Cir. 1990) (holding that corporate officer or director that misappropriates funds governed by Arizona's construction trust fund statute, Ariz. Rev. Stat. § 33-1005 (2003), can be held personally liable for such misappropriation and such debt may be non-dischargeable in bankruptcy); Md. Code Ann. Real Prop, § 9-202 (1996 Repl. Vol.); *People v. Brown*, 239 Mich. App. 735, 610 N.W.2d 234 (2000)(holding that individual that personally misappropriates funds can be held personally liable under Michigan's construction trust fund statute, Mich. Comp. Law § 570.152 (1996)); Okla. Stat. tit. 42, § 153 (2001).

<sup>33</sup> Md. Code Ann. Real Prop, § 9-201-02 (1996 Repl. Vol.) (imposing liability on officers, directors or managing agents that have "direction or control of money held in trust."); *People v. Brown*, 239 Mich. App. 735, 610 N.W.2d 234 (2000)(holding that individual that personally misappropriates funds can be held personally liable under Michigan's construction trust fund statute, Mich. Comp. Law § 570.152 (1996)).

proof of the officer's or director's intent to defraud the trust beneficiary.<sup>34</sup> Such an officer or director may be personally liable even if the construction trust fund statute does not so provide.<sup>35</sup>

A construction trust fund statute provides significant protection in the event that a contractor files for bankruptcy. When a contractor files bankruptcy, the owner, the subcontractors, and the contractor's surety are understandably concerned. If the contractor can use the funds received from the owner for any purpose, the owner faces a dilemma. If it pays the contractor/debtor and the contractor/debtor fails to pay its subcontractors, those subcontractors may have lien rights under applicable state law. If the subcontractors obtain liens, the owner may pay twice for the work. The subcontractors are likewise worried that the contractor/debtor will redirect the funds and the subcontractors will need to incur the transaction costs of filing a lien or a claim on the contractor's bond to obtain payment, or that such remedy may be barred by a notice or limitations provision. The trust fund statute resolves these problems. It protects the owner from liens, the subcontractors from non-payment, and the surety from claims by protecting the funds paid or to be paid by the owner from the claims of the contractor/debtor, its trustee, or its creditors.<sup>36</sup> Pursuant to section 541(d) of the Bankruptcy Code, property in which a debtor holds only legal title and not equitable title becomes part of the debtor's bankruptcy estate only to the extent of debtor's legal title.<sup>37</sup> If there is a valid trust in existence, "property of the debtor held in trust at the time of filing its bankruptcy petition is excluded from the bankruptcy estate."<sup>38</sup> To the extent that there is a valid trust in existence, construction trust funds paid to the debtor after the filing of bankruptcy are held by the debtor subject to the trust obligations.<sup>39</sup>

Normally, a debt resulting from the debtor's defalcation while acting in a fiduciary capacity can be exempted from discharge.<sup>40</sup> The courts have consistently limited the meaning of "fiduciary capacity" to express or technical trusts.<sup>41</sup> The requisite trust

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<sup>34</sup> Md. Real Prop. Code Ann. § 9-202 (1996).

<sup>35</sup> See, e.g. *Woodworking, supra*, 114 B.R. 1981.

<sup>36</sup> The mechanics of what must be done in the bankruptcy court (e.g., filing a motion for relief from automatic stay or to prohibit use of cash collateral) are beyond the scope of this article. These rights can usually be enforced by the debtor's surety as well. See 11 U.S.C. § 362(d) (party in interest can move for relief from automatic stay); 11 U.S. C. § 363(e) (party in interest may move to condition or prohibit debtor's use of cash collateral).

<sup>37</sup> 11 U.S.C. § 541(d).

*In re B.I. Fin. Servs. Group, Inc.*, 854 F.2d 351, 354 (9<sup>th</sup> Cir. 1988) (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.10 (1983)).

<sup>39</sup> See *Universal Bonding Ins. Co. v. Gittens & Sprinkle Enterprises, Inc.*, 960 F.2d 366, 372-73 (3d. Cir. 1992).

<sup>40</sup> 11 U.S.C. §523 (a)(4).

<sup>41</sup> See *Davis v. Aetna Acceptance Corp.*, 293 U.S. 328, 333 (1934).

relationship must exist prior to and without reference to the act of wrongdoing.<sup>42</sup> This requirement eliminates constructive, resulting, or implied trust from the scope of fiduciary obligations that will support a finding of non-dischargeability.<sup>43</sup> Several courts have addressed the question of whether a violation of a construction trust fund statute can support a finding of non-dischargeability. For those statutes which provide solely criminal remedies, the courts have generally held that misappropriation of the trust funds does not support a finding of non-dischargeability.<sup>44</sup> They view such statutes as closer to constructive or resulting trusts. For construction trust fund statutes that do not require segregated accounts but do create express trust requirements that arise before any wrongdoing, the courts generally hold that a misappropriation of the trust funds will support a finding of non-dischargeability.<sup>45</sup> Likewise, statutes that require the contractor to segregate and keep detailed records of the funds find the trust to be sufficient to support a determination of non-dischargeability.<sup>46</sup> Thus, the terms of the statute must be closely analyzed to see if a sufficient fiduciary capacity is imposed upon the trustee to support a finding of non-dischargeability.

Most construction trust fund statutes set forth little or no procedural requirements for the maintenance of the trust funds and may expressly permit commingling of trust and non-trust funds.<sup>47</sup> Other statutes require that detailed accountings be kept for each trust.<sup>48</sup> If commingling is permitted, the funds do not lose their trust nature as a result.<sup>49</sup>

It is important for owners, contractors and subcontractors to understand the applicable construction trust fund statute, assuming there is one that will govern a particular project as a construction trust fund statute may provide useful remedies and may also impose significant obligations and penalties. It is also important that the case law interpreting the applicable construction trust fund statute be carefully reviewed to determine how liberally or conservatively courts have applied the obligations and remedies provided by the statute.

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<sup>42</sup> *Ragsdale v. Haller*, 780 F.2d 794, 796 (9<sup>th</sup> Cir. 1986).

<sup>43</sup> *Davis*, 293 U.S. at 333.

<sup>44</sup> *In re Pedrazzini*, 644 F.2d 756 (9<sup>th</sup> Cir. 1981) (California law); *In re Cross*, 666 F.2d 873 (5<sup>th</sup> Cir. 1982) (Georgia law); *In re Angelle*, 610 F.2d 1335 (5<sup>th</sup> Cir. 1980) (Louisiana law); *In re Dloogoff*, 600 F.2d 166 (8<sup>th</sup> Cir. 1979) (Nebraska law); *but see In re Romero*, 535 F.2d 618 (10<sup>th</sup> Cir. 1976).

<sup>45</sup> *See In re Baird*, 114 B.R. 198 (BAP 9<sup>th</sup> Cir. 1990) (Arizona law); *Carey Lumber Co. v. Bell*, 615 F.2d 370 (5<sup>th</sup> Cir. 1980) (Oklahoma law); *In re Johnson*, 691 F.2d 249, 251 (6<sup>th</sup> Cir. 1982) (Michigan law); and *In re Martin*, 35 B.R. 982 (Bankr. E.D. Pa. 1984) (Delaware law). *But see Boyle*, 819 F.2d 583 (5<sup>th</sup> Cir. 1987) (Texas law); and *In re Rausch*, 49 B.R. 562 (Bankr. D.N. J. 1985) (New Jersey law).

<sup>46</sup> *In re Kawczynski*, 442 F. Supp. 413 (W.D.N.Y. 1977).

<sup>47</sup> *See, e.g.*, Md. Code Ann. Real Prop., §§ 9-201, *et seq.* (1996 Repl. Vol.).

<sup>48</sup> *See* N.Y. Lien Law § 75 (McKinney 1993).

<sup>49</sup> Md. Code Ann. Real Prop., § 9-201(c) (1996 Repl. Vol.)

#### **IV. CONCLUSION**

Payment provisions can have significant financial consequences for any party that has assumed the risk of non-payment, and can have significant financial benefits for the party that has shifted the risk of non-payment. Parties negotiating a construction contract should closely scrutinize conditional payment provisions to determine the effect of such provisions *before* entering into the contract. Likewise, construction trust fund statutes can provide useful remedies to owners, contractors, subcontractors, and sureties. The party charged with maintaining a construction trust fund should be familiar with specific requirements of the statute prior to the commencement of the construction project in order to ensure compliance with any procedural requirements and to avoid liability for remedies available under the statute.