

## Joint Check Agreements in Construction: Use with Caution

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Construction projects involve a tiered relationship, which consists of (a) the project owner, (b) a general contractor hired by the owner who manages the construction project as a whole, (c) first-tier subcontractors hired by the general contractor to complete discrete portions of the project work, and (d) lower-tier subcontractors and suppliers who are hired to complete portions of the upper-tier subcontractors work or to supply materials to upper-tier subcontractors.

Generally, under this tiered system, the owner pays the general contractor, the general contractor pays each of its first-tier subcontractors from the funds it receives from the Owner, the first-tier subcontractors pay their second-tier subcontractors and suppliers from the funds received from the general contractor and so-on. If, however, a first or second-tier subcontractor fails to pass along payment to its subcontractors or suppliers, then the unpaid subcontractor or supplier can assert its payment and lien rights against the owner, general contractor, and upper-tier subcontractors as provided by North Carolina law. This subjects owners and especially general contractors to the threat of having to pay twice for the same work. Therefore, general contractors have a key interest in ensuring that payment makes its way down to second and third-tier subcontractors.

Joint check agreements provide one such avenue for owners and general contractors to address the double payment issue and ensure that payments are being passed along to lower-tier subcontractors. Joint check agreements are a common form of an agreement entered into on construction projects that enables or requires a contractor or subcontractor—Party A—to pay its subcontractor—Party B—by a joint check that lists both the subcontractor and its lower-tier subcontractor—Party C—as payees. A joint check is a check made out to two parties that can only be cashed if signed by both parties. Because the check must be signed by both parties before it is cashed, it makes it difficult for Party B to take the money and not pay Party C.

Joint check agreements are often entered into between a general contractor ("Contractor"), its first-tier subcontractor ("Subcontractor"), and a second-tier material supplier ("Supplier") for the purpose of protecting the Supplier's right to payment. As a result of the agreement, the Contractor agrees to pay its Subcontractor by joint checks, which list both the Subcontractor and Supplier as payees. To cash the joint check, it has to be signed by both the Subcontractor and the Supplier. Thus, the Supplier is provided notice of each payment made from the Contractor to the Subcontractor and can more easily ensure that it receives timely payment from the Subcontractor. In fact, it is often the Supplier who demands a joint check agreement as a condition to it agreeing to supply materials to the Subcontractor for the given construction project. For example, a Supplier might demand a joint

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check agreement when it is concerned about the creditworthiness of the Subcontractor or if it has never worked with the Subcontractor and wants some additional protection for its payment rights. In addition to the Supplier, the joint check agreement benefits the Contractor as it encourages the Subcontractor to timely disburse payments to the supplier and reduces the risk of non-payment to the Supplier and the likelihood of the Supplier filing a mechanic's lien on the project.

While joint check agreements can be a helpful tool, they can give rise to a range of issues and disputes between the parties to the agreement. North Carolina courts have yet to fully address the legal issues that can arise from a joint check agreement, but the Courts of other states have identified numerous issues that can arise from joint check agreements, including (1) whether the joint check agreement is properly executed by the parties and enforceable; (2) whether the joint check agreement creates an independent obligation for the Contractor to pay the Supplier; and (3) whether the Supplier's endorsement of a joint check impacts its payment and lien rights. Contractors, Subcontractors, and Suppliers should be aware of these issues and proceed with caution when negotiating a joint check agreement or deciding whether to enter into a joint check agreement.

## **Formation and Enforceability of Joint Check Agreements**

First, there are a few issues that can arise regarding the proper formation of an enforceable joint check agreement. To be enforceable, joint check agreements generally require the consent and agreement of all parties, as evidenced by a written agreement signed by all parties. This is because many contracts between a Contractor and Subcontractor cannot be modified except by a written agreement signed by both the Contractor and Subcontractor. Because joint check agreements modify the Subcontractor's payment rights under the subcontract, the parties usually must formalize any joint check agreement in a written document signed by all parties. In fact, if a Contractor were to unilaterally agree to a joint check agreement and pay its Subcontractor by joint check without the Subcontractor's written consent, the Subcontractor could potentially argue that the Contractor breached its payment obligations under the subcontract. Likewise, the contract between the Subcontractor and Supplier may also require any modification to the parties' rights thereunder to be evidenced by a signed writing. Therefore, before entering a joint check agreement, the parties should review the direct contractual obligations they've already assumed and consider what formalities will be required to create an enforceable agreement. In the absence of a written agreement signed by all parties, the Supplier may run into some hurdles in attempting to enforce the joint check agreement.

Another issue that can impact the enforceability of joint check agreements is whether the Contractor is receiving any new consideration or benefit in return for its promise to pay by joint check. Consideration refers to the exchange of benefits and detriments that accompanies a contract. If, for example, the Contractor is not receiving any new benefit in exchange for its promise to pay by joint checks, then the agreement may be found to be lacking consideration and deemed unenforceable. Generally, a promise to perform a pre-existing contractual obligation is not an adequate benefit to the promisor to create a binding contract. Thus, if the Supplier is already obligated to supply materials to the project at issue, it may need to show that it is providing some new consideration or value to the Contractor in exchange for the Contractor's promise to pay the Subcontractor and Supplier by joint check.

## **Contractor's Potential Liability to Supplier under Joint Check Agreement**

Another issue that arises in the context of joint check agreements is whether, by executing the joint check agreement, the Contractor potentially undertakes an independent payment obligation to the

material Supplier with whom it is otherwise not in a direct contractual relationship. The answer depends on the terms the parties agree to in the joint check agreement. Contractors can knowingly or unknowingly assume a direct obligation to the Supplier if the agreement can be read as creating such a direct obligation. Whether the Contractor has assumed a direct payment obligation to the Supplier in the joint check agreement will be governed by the intent of the parties as demonstrated in the agreement itself. For example, where the language of a joint check agreement makes clear that the Contractor intended to pay the Supplier for all materials it supplied to the Subcontractor for use on the project without respect to what the general contractor owed to its Subcontractor, the joint check agreement may be found to create a direct payment obligation from the Contractor to the Supplier. This result, however, can be avoided if the joint check agreement is drafted in a way that makes clear that the Contractor is not undertaking an independent obligation to pay the supplier but merely agreeing to make its required payments to its Subcontractor by joint check. As this issue demonstrates, the parties to a potential joint check agreement should not enter into the agreement until they or their attorneys have closely scrutinized the terms of the joint checking agreement and feel comfortable with the obligations they are assuming and the rights they are receiving as a result of the agreement.

## **Joint Check Agreement's Impact on Supplier's Payment and Lien Rights**

Lastly, Joint Check Agreements can also impact the Supplier's payment and lien rights. Under a rule applied in some jurisdictions known as "the joint check rule," when a Subcontractor and a material Supplier are joint payees, and no agreement exists with the Contractor as to the allocation of the joint check proceeds, the Supplier by endorsing the joint check is deemed to have received the money due to him.<sup>[1]</sup> Because a Supplier can be treated as having received the money due to him by endorsing the joint check, the endorsement can impact the Supplier's rights to assert a claim for non-payment or to assert a lien claim, even if the Supplier did not in fact receive the payment owed to it after endorsing the joint check. This result can also be changed by adding language to the agreement that negates the application of the joint check rule. Additionally, the supplier can demand immediate payment upon endorsing the joint check in an effort to ensure the joint check rule is not applied to its detriment. In any case, this issue again demonstrates that joint check agreements can have consequences, and the parties should not enter into these agreements on a whim and without understanding their rights and obligations under the agreement.

In conclusion, joint check agreements can be useful tools for construction projects. It is important, however, that the parties who use these agreements understand that entering into a joint checking agreement can have unintended consequences if the terms of the agreement are not thoughtfully drafted and scrutinized prior to the consummation of the agreement. Thus, we recommend that Contractors, Subcontractors, and Suppliers use caution when entering into joint check agreements and consult with in-house counsel or your attorney to understand the rights you are receiving and the obligations you might be assuming as a result of executing a joint check agreement.

<sup>[1]</sup> E.g., *Post Bros. Constr. Co. v. Yoder*, 569 P.2d 133 (Cal. 1977).