

CONTRACT KNOWLEDGE

Critical Provisions

knowing the consequences of owner insolvency

By Andrew N. Schock, Patrick F. Estill, and Danielle M. Waltz



Pay-if-paid and pay-when-paid provisions and their legal effect can have critical consequences for contractors on construction projects when an owner becomes insolvent or fails to pay a general contractor. The way these provisions are interpreted and applied differently in some jurisdictions is discussed together with recent legislation prohibiting or limiting the effect of such provisions.

PROVISION PAIN POINTS

Few clauses in a construction contract create more ire for subcontractors and suppliers than the infamous pay-if-paid and pay-when-paid provisions. Often found in standard subcontracts or purchase orders, general contractors employ such provisions to limit liability to subcontractors and suppliers in the event an owner fails to pay the general contractor. These clauses provide an obvious benefit to general contractors, who may have a legitimate argument that they are not project financiers and should not bear the ultimate risk of owner non-payment. At the same time, the subcontractor or supplier may not be in an equal bargaining position to dispute such provisions, and therefore often reluctantly agree to a contract containing them. While such clauses are generally upheld, there appears to be a trend toward prohibiting or limiting the impact of such clauses—which may be a welcome relief to subcontractors and suppliers. Should this trend continue or should courts uphold such provisions in the spirit of freedom of contract?

PAY-IF-PAID PROVISION

In some states, such as Ohio, courts have generally upheld pay-if-paid provisions if they contain sufficient, explicit language evidencing the intent that payment by the owner is an express condition precedent to the contractor's duty to pay the subcontractor. *See Transtar Elec., Inc. v. A.E.M. Elec. Servs. Corp.*, 2014-Ohio-3095, 140 Ohio St. 3d 193, 16 N.E.3d 645. A pay-if-paid provision may read: "The obligation of the General Contractor to make payment to Subcontractor under this Agreement is subject to the express condition precedent of payment therefore by the Owner." Such a provision, if upheld, shifts the risk of nonpayment by the owner from the general contractor to the subcontractor or supplier. Jurisdictions that enforce such provisions generally do so in recognition of the parties' right to freely contract. Nonetheless, there is typically a high level of scrutiny applied to these provisions, which must make it clear that there is a condition precedent to payment by the general contractor to the subcontractor or supplier.

PAY-WHEN-PAID PROVISION

If the provision is a pay-when-paid provision, the risk of loss generally does not pass to the subcontractor or supplier. *See Chapman Excavating Co. v. Fortney & Weygandt, Inc.*, 8th Dist. Cuyahoga No. 84005, 2004-Ohio-3867. A pay-when-paid provision may read: "Contractor shall pay Subcontractor when Contractor receives payment from the Owner." Despite the literal language of such provisions, most courts interpret pay-when-paid provisions

as creating an absolute obligation to pay, subject to a time limitation. Under a pay-when-paid provision, the general contractor is generally liable to the subcontractor or supplier after a reasonable period of time, even if the owner never pays the general contractor. Nonetheless, general contractors and subcontractors or suppliers often disagree on the meaning and effect of their specific contract when the owner becomes insolvent or otherwise fails to pay. The nuanced law on these provisions varies by state, so it is important for contractors to understand the law on these provisions in the states where they are working prior to agreeing to a contract containing these provisions.

ENFORCEABLE OR NOT

Conditional payment provisions such as pay-if-paid and pay-when-paid provisions are generally upheld, and have been enforced in various states such as Ohio, Kentucky, West Virginia, and Pennsylvania. In Kentucky, for example, pay-if-paid clauses are generally enforceable if they are unambiguous. Like in other jurisdictions allowing such clauses, this requirement is typically met in Kentucky by making payment by the owner an express condition precedent to the contractor's obligation to pay the subcontractor. *See Superior Steel, Inc. v. Ascent at Roebling's Bridge, LLC*, 540 S.W.3d 770, 784 (Ky. 2017). In other states, pay-if-paid provisions may be unenforceable. In states such as New York and California, courts have refused to enforce pay-if-paid provisions on the basis

that they violate public policy. See *West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 661 N.E.2d 967 (1995). See also *Wm. R. Clarke Corp. v. Safeco Ins. Co.*, 15 Cal. 4th 882, 938 P.2d 372, (1997). In other states, such as Virginia, North Carolina, and Wisconsin, the legislature has enacted laws prohibiting or limiting pay-if-paid provisions. The most recent example of this is in Virginia, where a law effective Jan. 1, 2023, (Virginia Code §§ 2.2-4354 and 11-4.6) prohibits pay-if-paid clauses and limits the time for payment to a maximum of 60 days under pay-when-paid provisions.

CLOSING THOUGHT

Parties on both sides of a subcontract should understand the effect of pay-if-paid and pay-when-paid provisions in their jurisdiction and assess the risk of any given contract prior to agreeing to its terms. The failure of a party to do so may result in the unintended consequence of that party—whether the GC or the subcontractor—becoming the de-facto financier of a project. ■

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