Contracts BULLETIN
a SMACNA publication
HVAC Industrial Architectural Metal
EXPERTISE
PERFORMANCE • TRAINING • STANDARDS

Volume 0, Issue Number 0 January 13, 2004

Bulletin #73, "Pay–When–Paid" Clauses – A Gateway into the Unknown (January 13, 2004)

"Pay–if–paid" or "pay–when–paid" clauses are often used in contracts between general contractors and subcontractors. The clauses usually provide that a general contractor is not required to pay a subcontractor unless and until the project owner pays the general contractor. These provisions may cause a subcontractor to suffer a significant hardship. The enforceability of the clauses varies greatly from state to state. Before a subcontractor accepts such a provision, it should understand the clause and know whether it is enforceable in its state.

The Clause – Defined

Some general contractors have shifted the responsibility of collection to subcontractors through "pay–when–paid" clauses. In effect, the provision seeks to transfer from the general contractor to the subcontractor the credit risk for an owner's non–payment. The following are two examples of such clauses:

- *Receipt of funds by the Contractor from the Owner is a condition precedent to the Contractor's obligation to pay Subcontractor under this Agreement, regardless of the reason for the Owner's non–payment, whether attributable to fault of the Owner, Contractor, Subcontractor or due to any other cause.*

- *The receipt of . . . payments by the* [general contractor] *is a condition precedent to payments to the subcontractor.*

Treatment by the States

Clause Unenforceable

A few states have held that "pay–when–paid" clauses are unenforceable contract provisions. That is, even if these provisions are contained in the contract, the courts will not allow the general contractors to enforce the provisions. The legislatures of North Carolina and Wisconsin have barred enforcing these clauses entirely. Similarly, the highest courts in California and New York have made decisions, which have a similar effect of barring the enforceability of these provisions in their states. Additionally, statutes in Illinois, Maryland, Missouri, and Ohio will not enforce pay–when–paid clauses where a subcontractor's mechanic's lien is at stake.

Minority Rule

In a small number of states, led by the Florida Supreme Court, subcontractors will be held strictly accountable for the language in a pay−when−paid provision. Put another way, if a pay−when−paid clause is in a contract, a subcontractor will **only** be paid if the general contractor has been paid by the owner. This harsh reading of the contract can lead to devastating results for subcontractors when owners do not pay. Nevertheless, a minority of states will enforce these clauses regardless of the impact on subcontractors.

Majority Rule

Most states have refused to follow the harsh reading of the Minority Rule. Instead, these states have read pay−when−paid clauses to merely provide (regardless of the language of the clause itself) a reasonable time for payment by the general contractor to the subcontractor without relieving the general contractor of its obligations to pay the subcontractors. Under this rule, followed by a majority of states, the general contractor can delay payment to the subcontractor if the owner is tardy in payment. However, the general contractor will ultimately be liable to the subcontractor even if the owner does not pay.

"Contract Construed Against the Drafter"

There is an important rule in reading contracts: all contracts will be construed or read against the drafter. Because most agreements between contractors and subcontractors are written by the general contractor (especially contracts containing pay−when−paid clauses), courts will interpret any unclear or ambiguous language in the contract against the general contractor and to the advantage of the subcontractor. For example, in Minnesota a contract provided:

> *Final payment including all retention becomes due and payable within 30 days after Architects' certification of final payment. At all times the Subcontractor shall be paid the extent that the Contractor has been paid on the Subcontractor's account.*

The court found the provision to be sufficiently unclear to prevent a contractor from arguing that this was an enforceable "pay−when−paid" clause. The court said that if the language is unclear, the provision should be read against the general contractor. The court refused to enforce the provision as a pay−when−paid clause.

"Unconscionable"

Courts have also refused to enforce pay−when−paid clauses because they are "unconscionable." Unconscionable means a clause is unfair because there is a significant difference in bargaining power between the two parties, or because to enforce the provision would "shock the conscious" of society. Here, commentators and courts have argued that it would be grossly unfair to shift the risk of owner non−payment to the subcontractor when the general contractor (and not the subcontractor) is in the best position to assess the owner's credit worthiness. Indeed, most subcontractors have no contact whatsoever with the owners. As discussed above, only two courts (California and New York) have found pay−when−paid provisions to be unenforceable on these grounds alone. Most courts look to the language of the clauses and attempt to interpret the terms of the clauses on a case−by−case basis.

Significance of Uncertainty

Unless you are in one of the states which has refused to enforce these provisions, you need to be extremely careful. The implications of an owner failing to pay for work with no recourse against the general contractor are obvious. Subcontractors usually provide substantial value to a project through labor and materials. The general contractor often provides only job oversight. Therefore, the party taking the significant financial "hit" is the subcontractor if pay−when−paid clauses are enforced.

The safest and best approach is to remove these clauses whenever they are included in a contract, regardless of the state in which you are doing business. If you are doing business in a state which bars these

provisions, an owner should have no objection to removing them because they are unenforceable.

The implications of these pay−when−paid clauses for subcontractors providing services in multiple states are also important. Usually multi−state projects involve a large and complex construction contract (often an AIA form). You should be aware that such contracts usually contain a “choice of law” clause which designates the state whose law will govern in any disputes between the parties. If the contract designates a state which does not ban pay−when−paid clauses, the subcontractor will be held accountable to the extent an owner does not pay.

Protecting Yourself

If you are doing business in a state which permits pay−when−paid provisions, you should:

- Require the provisions be removed from your contract;
- Require a personal guaranty or letter of credit from the owner; or
- Strongly consider refusing to sign a contract if you are not provided with one of the first three items above.

Additionally, if you are a subcontractor in a project containing a pay−when−paid clause, you are now playing a significant financial role in the project and are in the position a general contractor traditionally occupies with respect to the owner. Accordingly, you should receive financial records confirming timely payment to all other subcontractors and copies of communication with the bank concerning the release of any construction loan payments. If you see evidence that the owner is failing to make timely payments, you should consult with your attorney to discuss limiting your labor or materials on the job until you receive adequate assurance that you will be paid.

Conclusion

The refrain in virtually all *Contracts Bulletins* is that contracts **must** be carefully read. However, pay−when−paid clauses present an especially serious issue for subcontractors. A general contractor usually has a relationship with the owner to assess their financial ability to make payments during the project. Additionally, the general contractor has a global view of the project and should know when an owner becomes “behind” in payments.

A pay−when−paid clause shifts the obligation of collection from the general contractor to the subcontractor. Unless the subcontractor removes, modifies, or engages in other activity to limit its risk, it could find itself “holding the bag” when an owner defaults.

As discussed above, the law on this issue is in flux and changing from state to state. Unless you are in a state which has clearly prohibited such clauses, you should consult with your attorney before you accept such a clause.

Sheet Metal and Air Conditioning Contractors' National Association
4201 Lafayette Center Drive Chantilly, Virginia 20151−1209
Tel (703) 803−2980 Fax (703) 803−3732 info@smacna.org