

Are “Pay When Paid” Clauses Valid?

It Depends on Your Jurisdiction

By Matthew DeVries

As you may be aware, one of the greatest risks on a construction project involves the payment process. Particularly in these economic hard times, a contractor and its subcontractors and suppliers expect to be paid on a timely basis once the work has been performed. Contractors have a means of shifting the risk of non-payment by the owner to the subcontractor by including a “pay when paid” or “pay if paid” provision in their subcontract. A “pay when paid” clause contemplates that payment will be made by the contractor “when” payment is received by the owner, whereas the “pay if paid” clause requires payment only “if” the owner pays the contractor. In other words, the first clause is about timing of payment, while the second clause is about whether payment is even required when the owner does not pay. The enforceability of these types of clauses may be limited by your particular state or jurisdiction.

In *Universal Concrete Products Corp. v. Turner Construction Co.*, the U.S. Court of Appeals for the Fourth Circuit concluded that a “pay if paid” clause in a subcontract was not ambiguous and, therefore, the provision was enforceable against the subcontractor. The work involved the construction of the Granby Tower Project in Norfolk, Virginia. The subcontract between the general contractor and the concrete subcontractor contained the following clause:

“The obligation of contractor to make payment under this agreement, whether a progress or final payment, or for extra or change orders or delays to the work, is subject to the express condition precedent of payment therefore by the owner.”

The owner ultimately lost its construction financing on the project

and abandoned the development. Since the contractor had not been paid for its work, it refused to pay the subcontractor’s work. In a payment dispute between the subcontractor and contractor, the contractor argued that the “pay if paid” clause provided an absolute defense to payment. (Again, it should be noted that some states limit the enforceability of these clauses by either statute or case law. However, in Virginia, these types of clauses are enforceable so long as they are clear and unambiguous.)

The subcontractor argued that the prime contract between the owner and the contractor defined the cost of work to include “payments made” to subcontractors. Both the trial court and the appellate court disagreed, finding that payment from the owner was a condition precedent to payment from the contractor to the subcontractor.

Courts across the country vary in their treatment of these issues. For example, in the *Universal Concrete Products* case, the Fourth Circuit reasoned that Virginia courts favor the freedom to contract, and that parties are freely able to negotiate and draft these types of provisions. However, in *Thomas J. Dyer v. Bishop International Engineering*, the Sixth Circuit refused to enforce a “pay when paid” clause because the court determined that the clause was sufficiently ambiguous. In that case, the contract stated that “no part of payment shall be due until 5 days after the owner shall have paid the contractor.” Other jurisdictions, such as California, New York, and Nevada, have expressly ruled that the “pay if paid” clauses are unenforceable as a violation of state public policy.

So, what should your contracts provide? What should you do to determine the enforceability of a “pay if paid” clause in your state?

- **Speak with an attorney in your state to determine whether there are any limitations of the enforcement of these type of clauses.** Since each state differs dramatically, it is in your best interest to determine the applicable standard in your state, or the applicable law where the project is located, or the governing law of the contract to determine this information.
- **Determine as between the parties who should bear the risk of non-payment.** If you are a general contractor, you should make sure that your subcontracts include clear and unambiguous language placing the risk of loss for non-payment on the subcontractor. In addition to putting a timing mechanism on payment of funds to the subcontractor following a certain number of days after payment by the owner, it is also advisable to include a clause that “payment by the owner to the contractor is a condition precedent to payment by the contractor to the subcontractor”. In addition, you can make your subcontracts explicitly clear by stating that “the subcontractor assumes the risk of non-payment by the owner due to insolvency or other inability to pay”.

For the contractors out there, *Universal Concrete Products* is a good reminder of the importance of drafting clear and unambiguous contract terms between the parties. It is worth the effort to find out the answer to these types of questions prior to drafting and executing contracts with other parties. ■

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