Chipping Away at the Armor of Pay-if-Paid Provisions

In tough economic times it is not surprising to see an increase in subcontractor claims related to unpaid invoices or applications for payment. It is also not surprising that prime contractors increasingly armor plate their subcontracts to shield against subcontractor payment claims when the payment claim arises as the result of the project owner’s failure to pay the contractor. Thus, an increasingly important issue in complex, multi-tiered, construction contracts involves the question regarding which party ultimately bears the risk of loss when a project owner becomes insolvent or otherwise defaults in its payment obligations to the prime contractor. To shield themselves and shift to their subcontractors the risk of owner nonpayment, prime contractors increasingly use pay-if-paid provisions in their subcontracts instead of pay-when-paid provisions. Thus, it is critically important to recognize and understand the significant difference between a pay-when-paid and a pay-if-paid provision. It is equally important to recognize when there are chinks in the armor of a pay-if-paid provision subjecting the provision’s enforceability to a potentially fatal attack.

What is the difference between a pay-when-paid and a pay-if-paid provision?

A pay-when-paid provision controls only the timing of the contractor’s payment obligation, not the contractor’s ultimate duty to pay the subcontractor. Typically, a pay-when-paid provision provides that the subcontractor will be paid within some fixed time period after the project owner pays the contractor. A typical pay-when-paid provision, for example, may provide that the “Contractor shall pay Subcontractor within 10 days of Contractor’s receipt of payment from the Owner.” If the subcontract contains a pay-when-paid provision, and if the owner fails or refuses to pay the contractor, the contractor remains obligated to pay the subcontractor. While the contractor’s obligation to pay the subcontractor would likely be suspended to allow the contractor time to collect payment from the owner, the courts will generally construe a pay-when-paid provision to require the contractor to pay the subcontractor within some reasonable period of time even if the contractor is never paid.

In stark contrast, a pay-if-paid provision shifts the risk of the owner’s nonpayment from the contractor to the subcontractor. A typical pay-if-paid provision, for example, may provide that the “Contractor’s receipt of payment from the Owner is a condition precedent to Contractor’s obligation to make payment to the Subcontractor and the Subcontractor expressly assumes the risk of the Owner’s nonpayment and the Subcontract price includes this risk.” A “condition precedent” is a legal term of art which Black’s Law Dictionary defines as “an act or event, other than a lapse of time, that must exist or occur before a duty to perform something promised arises.” Thus, the language in this example means that the Contractor’s duty to pay the Subcontractor is expressly conditioned on the Contractor’s receipt of payment from the Owner. For those seeking the protection of a pay-if-paid provision, careful drafting of the contract language is essential. Generally, pay-if-paid provisions must clearly and unambiguously indicate that the intent of...
the contracting parties is to shift the risk of the owner’s nonpayment from the contractor to the subcontractor. The provision must alert the subcontractor that the subcontractor must ultimately look to the project owner for payment.

Can an unpaid subcontractor successfully attack the enforceability of a paid-if-paid provision?

When a subcontractor is faced with a contractor’s refusal to pay the subcontractor’s invoices because the owner has failed to pay the contractor, the subcontractor often looks for ways to avoid the harsh result of a pay-if-paid provision. For example, subcontractors have attacked the enforceability of pay-if-paid provisions (1) based on statutory grounds, (2) based on public policy considerations, (3) where the provision was ambiguous, (4) where the contractor’s wrongful acts prevented payment by the owner, and (5) where facts and circumstance suggested that the provision had been waived.

Several state legislatures have enacted legislation to limit the enforceability of pay-if-paid provisions and the courts in several states have declared such provisions to be against public policy and, therefore, unenforceable. Note, however, in the majority of states, pay-if-paid provisions are strictly enforced.

Ambiguous pay-if-paid provisions may be unenforceable. Some courts, for example, have found that a pay-if-paid provision in a subcontract is ambiguous and unenforceable where the prime contract contains language that obligates the contractor to certify that the subcontractor has been paid before the owner is obligated to pay or reimburse the contractor.

The "prevention doctrine" operates to void pay-if-paid provisions where a contractor precludes successful completion of the contract. The prevention doctrine is based on the general principle of contract law that where one party hinders, prevents or makes performance impossible by the other party, the latter’s failure will be excused. Numerous courts have voided pay-if-paid provisions using the prevention doctrine where the contractor’s actions prevented payment from the owner. In some states, a contractor cannot rely on the pay-if-paid provision when the contractor frustrates or prevents the owner’s payment as a result of the contractor’s own material breach of the prime contract.

Finally, it is possible for the contractor to waive a pay-if-paid provision. For a waiver to exist there must be an intentional relinquishment of a known right. The Georgia Court of Appeals recently considered whether a contractor had waived a pay-if-paid provision where the contractor’s project manager told the subcontractor that the contractor would pay the subcontractor out of this “own pocket” if necessary and paid one of the subcontractor’s payment applications despite not having been paid in full by the owner. See Vratsinas Construction Co. v. Triad Drywall, LLC, 2013 WL 1189260 (Ga.App. Mar. 25, 2013). Following a jury trial, the trial court entered a judgment in favor of the subcontractor. The appellate court reversed. Because the specific facts and circumstances essential to the waiver issue had been clearly established, the appellate court determined that the issue of waiver was a question of law to be decided by the court and should not have been submitted to the jury. The appellate court then determined that the contractor had not waived enforcement of the pay-if-paid provision because the contractor had declined to pay seven progress payment applications, repeatedly informing the
subcontractor that the contractor had not received payment from the owner. The evidence indicated that the subcontractor clearly anticipated and understood that owner payment to the contractor continued to be a prerequisite to the subcontractor’s receipt of payment from the contractor. The appellate court found that the conduct of the subcontractor and the contractor established a lack of intent or understanding that the contractor had waived the important contract right contained within and enshrined by the pay-if-paid provision.

State law varies regarding the enforceability of pay-if-paid provisions and varies regarding whether there are any exceptions to the enforceability of such provisions. Thus, whether you are a contractor planning to use a pay-if-paid provision in your subcontracts or a subcontractor on the receiving end of a pay-if-paid provision, it is important that you consult with your construction lawyer regarding the enforceability of such provisions.

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