Contingent Payment Clause Enforcement

Introduction

One frequent dilemma in construction contracting involves who should share in the financial risk when the owner fails to pay. Since the project owner provides the basic financing for the work, many general contractors believe that this financial risk should be shared by all of the contracting entities (prime and subcontractor). As a result, the contingent payment clause was born. Subcontractors and suppliers assert that such clauses are not reasonable as they look to their general contractor for payment and that it is the general contractor’s obligation to ascertain the owner’s financial capability. Many states will enforce contingent payment clauses, variously known as “pay-if-paid” or sometimes “pay-when-paid” clauses. Not only does the wording of these clauses vary from contract to contract, enforceability and validity of the clauses vary from jurisdiction to jurisdiction. Some courts adopt strict interpretation rules in determining the validity of contingent payment clauses, and recognize a distinction between these conditional payment clauses.

In a recent case out of the United States District Court for the Eastern District of Pennsylvania, the court recognized the distinction between “pay-if-paid,” where a contractor does not have a duty to pay a lower tier subcontractor until the contractor is paid by the owner, and a “pay-when-paid” clause, where a contractor has a reasonable time to pay its lower tier subcontractor, regardless of whether the owner has actually paid the contractor. According to that court, the distinction lies in the wording of the clause itself, and there must exist a very strongly worded provision conditioning payment before the risk of owner non-payment will shift to the subcontractor. In a period of severe, adverse financial conditions, these distinctions can be extremely important.

Pennsylvania Interpretation

In Sloan Co. v. Liberty Mutual Insurance Co., 2009 WL 2616715 (E.D. Pa. 2009) a subcontractor, Sloan, sued the general contractor’s payment bond surety after the general contractor failed to pay Sloan. The owner had not paid the general contractor, and Sloan’s subcontract with the general contractor contained a contingent payment clause. The surety argued that it was entitled to raise any and all defenses of the general contractor. Since the subcontract contained a clause conditioning the general contractor’s payment to Sloan on the general contractor’s receipt of payment from the owner, and the owner had not paid the general contractor, the surety argued it was not liable under the bond.

The key issue was whether the payment clause in the subcontract was a “pay-if-paid” clause which does not require a contractor to pay a subcontractor until the contractor receives payment or a “pay-when-paid” clause which “merely creates a timing mechanism for a contractor’s payments to a subcontractor and do not condition payments” based upon receipt of payment from an owner. The relevant clause in Sloan’s subcontract stated: “Final payment [to the Subcontractor] shall be made within thirty (30) days after the last of the following to occur, the occurrence of all of which shall be conditions precedent to such a final payment: . . . (6) Contractor shall have received final payment from the Owner for the Subcontractor’s Work.”

The Sloan court acknowledged that other courts have found phrases such as “condition precedent,” “if and only if,” and “unless and until” to be sufficient to establish that the agreement shifted the risk of non-payment to the subcontractor, and established a pay-if-paid defense for the contractor and its surety. The Sloan court, however, ruled that the presence of a single word or phrase such as “condition precedent” was insufficient to determine whether a provision was pay-if-paid or pay-when-paid. The court stressed the necessity of examining the contract as a whole to determine whether the intent of the parties was to shift the risk of non-payment to the subcontractor, and required strong evidence of such intent in order to find that a clause was a true pay-if-paid clause. The Sloan court ultimately held that the contingent payment clause (“condition precedent” language) in the subcontract did not clearly show an intent to shift the risk of the owner’s non-payment to the subcontractor, and was thus a pay-when-paid clause. Consequently, the subcontractor could recover from the surety the amount the subcontractor was owed.
Comment: court in *Sloan* is not the only court to find that a clause thought to be a pay-if-paid is really a pay-when-paid, based on the wording of the clause in question. Many jurisdictions, such as Florida, recognize the distinction. Other jurisdictions, such as Georgia, do not distinguish between pay-if-paid and pay-when-paid. In Georgia, there are no half measures - if a clause makes payment to a subcontractor conditional to payment by the owner that is the end of the analysis.

*Sloan* is not novel in its distinction between types of contingent payment clauses. The case is noteworthy, however, for the higher standard it places on contractors (and sureties) attempting to use the pay-if-paid defense. In *Sloan* the court looked for strong and clear language to demonstrate that the parties intended to shift the risk of owner non-payment to the subcontractor. The clause the court in *Sloan* found to be the most illustrative of a valid pay-if-paid clause stated “Subcontractor agrees that Contractor shall never be obligated to pay Subcontractor under any circumstances, unless and until funds are in hand received by Contractor . . . [t]his is a condition precedent to any obligation of Contractor, and shall not be construed as a time of payment clause.” Similarly, the *Sloan* court noted that the use of the phrase “final payment” rather than “full payment” was indicative of a provision addressing the timing of a payment.

One key point for contractors, sureties, and subcontractors is that contractors wishing to include contingent payment clauses in their subcontracts should err on the side of forceful language such as the clause the *Sloan* court cited approvingly. Using the phrases “shall never be obligated,” “condition precedent” and “shall not be construed as a time payment clause” apparently would be sufficient for a valid pay-if-paid defense in Pennsylvania, which is one of the jurisdictions imposing a higher standard on pay-if-paid defenses. By adopting the higher standard used in the *Sloan* case, contractors in jurisdictions such as Georgia should be amply protected.

Contractors using industry form contracts must also determine whether the contingent payment clause in the form contract contains strong enough conditional language, such as that mentioned in this article, or whether it contains weaker language that a court in a jurisdiction such as Pennsylvania might find insufficient to support a pay-if-paid defense. If the form contract’s contingent payment clause does not contain the strong conditional wording the *Sloan* court illustrated, the contractor may wish to substitute its own language.

One point made clear by the *Sloan* decision is that the law surrounding pay-if-paid provisions varies across jurisdictions. Any contractor or surety wishing to rely on a contingent payment provision and avoid bearing the full risk of owner non-payment must make sure the provision is drafted in such a way as to provide full protection. Alternatively, for subcontractors wishing to pierce the pay-if-paid defense of a nonpaying general contractor, the *Sloan* case potentially provides some ammunition for arguing that the clause in question does not establish that the general contractor and subcontractor agreed to shift the entire risk of owner non-payment to the subcontractor.