

Pay-if-Paid Clauses: Sometimes a Defense, Sometimes Not

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You are the general contractor or CM at risk on a project or perhaps you are the payment bond surety to the general contractor or CM at risk. The subcontracts or trade contracts used on this project include a pay-if-paid clause between the general contractor/CM at risk and the subcontractors/trade contractors. Because of the pay-if-paid clause, you feel protected against subcontractors' or trade contractors' claims for payment if the project owner becomes insolvent or otherwise refuses to pay for their work. But, can you always rely on that pay-if-paid clause to defend against a subcontractor's or trade contractor's payment claim? The answer depends on which state's law the court will apply to a subcontractor's/trade contractor's claim for payment. Indeed, that same pay-if-paid clause may be valid in one state, void in another state, a defense for the payment bond surety in one state and possibly no defense for that surety in another state. The key is knowing which law will apply to the pay-if-paid clause at issue.

Pay-if-Paid Clauses

Pay-if-paid clauses come in a variety of terms; but all seek to make payment to a lower tier subcontractor or trade contractor conditional on payment received first from a higher tier party, typically the project owner. When considering such clauses, courts will look for expressions of "condition precedent" or "assumption of risk of non-payment" or "risk of non-payment is on the subcontractor" or other such terms the courts interpret to demonstrate the parties' intent to shift the risk of the owner's non-payment or insolvency from the general contractor or construction manager to the subcontractor or trade contractor. This is not to say, however, that pay-if-paid clauses can only be created with magic language. Whether a particular clause creates a condition precedent to payment to a subcontractor or trade contractor is a question of construction, dependent on the intent of the parties as garnered from the words they employed in the clause. Consequently, words such as "if" or "condition" and phrases such as "only if and to the extent", "if and only if" or "unless and until" could be found sufficient to create a condition precedent to payment so long as the parties clearly and unambiguously expressed that to be their intention.

Enforcement of Pay-if-Paid Clauses

Those courts enforcing unambiguous pay-if-paid clauses may do so citing to the public policy principle of freedom of contract. Under this principle, in essence, the courts will enforce a contract as written, and the contract becomes the law of the case unless the contract or the particular clause is forbidden by some rule of law or is contrary to public policy. Relying on this principle, the Supreme Court of Appeals of West Virginia upheld the pay-if-paid subcontract terms at issue, finding the terms clear and unambiguous, and denied the subcontractors' payment claims when the project owner had not paid the claimed amounts to the general contractor. *Wellington Power Corporation v. CNA Surety Corporation*, 217 W.Va. 33, 614 S.E.2d 680 (2005).

Courts in other states such as Virginia, Florida, Pennsylvania and Ohio, to name some, have likewise acknowledged pay-if-paid subcontract clauses will be enforced under their state law when the terms clearly and unambiguously show the parties' intent to shift the risk of non-payment from the general contractor to the subcontractor. *See e.g., Galloway Corp. v. S.B. Ballard Construction Co.*, 250 Va. 493, 464 S.E.2d 349 (1995) (Virginia Supreme Court allowed parol evidence on parties' intent when agreeing to payment clause to resolve enforceability of such contract provisions.); *OBS Company Inc. v. Pace Construction Corporation*, 558 So.2d 404 (Fl. 1990); *DEC Electric, Inc. v. Raphael Construction Corporation*, 558 So. 2d 427 (Fl. 1990); *Sloan Company v. Liberty Mutual Insurance Co.*, 2009 WL 2616715 at *5, (E.D. Pa. 2009) ("Pennsylvania courts construe contract clauses that condition payment to a subcontractor on the contractor's receipt of funds from the owner of the project as 'pay-if-paid' clauses that do not require the contractor to pay a subcontractor until the contractor has received those funds from the owner of the project."); *Kalkreuth Roofing & Sheet Metal, Inc. v. Bogner Construction Company*, 1998 WL 666765 at *3 (Ohio 1998) ("Ohio courts have recognized a 'pay-if-paid' provision is binding and enforceable as long as such provision is undeniably clear and unambiguous as to the true intent and meaning of the clause.")

Statutory Preclusion of Pay-if-Paid Clauses

Other states have enacted statutes which make pay-if-paid clauses void and unenforceable. For example, North Carolina, N.C. Gen. Stat. § 22 C-2, South Carolina, S.C. Code 29-6-230, and Wisconsin, Wis. Stat. Ann. § 779.135(3), are three states that by law forbid pay-if-paid clauses.

Some commentators have also suggested that prompt payment statutes while not specifically addressing or expressly precluding pay-if-paid clauses, nonetheless, implicitly void contingent payment terms, such as pay-if-paid clauses.

Statutory Limitations On Enforcement of Pay-if-Paid Clauses

While not outright banning pay-if-paid clauses, some states legislatures have created exceptions to the enforcement of such clauses. For example, in Maryland, the Mechanic's Lien Statute, Real Property § 9-113(b) and (c), provides that a contingent payment provision or pay-if-paid clause in a subcontract may not abrogate or waive the right of the subcontractor to claim a mechanic's lien or sue on a contractor's bond. Any provision of a contract in violation of the statute is void as against the public policy of Maryland. The unanswered question under Maryland law is whether the statute voids pay-if-paid clauses altogether so that even the general contractor cannot rely on such a clause as a defense to an unpaid subcontractor's claim. Commentators, including the American Subcontractors Association in a June 2003 White Paper, suggest the Maryland Mechanic's Lien Statute creates but limited exceptions to the enforcement of such clauses because the statute does not preclude a general contractor's reliance on a pay-if-paid clause as a defense to a subcontractor's payment claim, nor does the statute categorically ban such clauses.

Other states have statutory exceptions to pay-if-paid clauses. For example, under Illinois statutory law, 770 ILCS 60/21, and Missouri statutory law, Mo. Stat § 431.183, contingent payment or pay-if-paid clauses cannot be a defense to a subcontractor's mechanic's lien claim.

Judicial Limitations On Enforcement of Pay-if-Paid Clauses

Courts in at least two states, New York and California, have judicially declared pay-if-paid clauses as contrary to their respective states' public policy. In *West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 638 N.Y.S. 2d 394, 661 N.E.2d 967 (1995), the New York state court found a truly conditional "pay when paid" clause that forces the subcontractor to assume the risk of an owner's non-payment to be in violation of New York's public policy as set forth in the state's Lien Law. In contrast, according to the court, a "pay when paid" clause which merely fixes a time for payment does not indefinitely suspend the subcontractor's right to payment upon the owner's failure to pay the general contractor and therefore does not violate the public policy as stated in New York's lien law.

Ironically, in two later rulings in 2005 and 2006, New York state courts have noted the prohibition against pay-if-paid clauses "... is not a deeply rooted tradition of this state.", *Hugh O'Kane Electric Co., LLC v. MasTec North America, Inc.*, 19 A.D. 3d 126, 128, 797 N.Y.S. 2d 45, 47 (2005), and "... given the checkered history of pay-if-paid clauses in the construction industry, we cannot say they are 'truly obnoxious,' *Welsbach Electric Corp. v. MasTec North America, Inc.*, 7 N.Y.3d 624, 632, 859 N.E.2d 498, 503, 825 N.Y.S. 2d 692, 697 (2006).

In California, the Supreme Court of California has ruled pay-if-paid clauses to be contrary to the public policy of the state and unenforceable, *Wm. R. Clarke Corp. v. Safeco Ins. Co. of America*, 15 Cal. 4th 882, 64 Cal. Rptr. 2d 578, 938 P.2d 372 (1997); and the California judicial rulings thereafter have shown no retreat from that holding.

Can Payment Bond Sureties Rely On Their Principals' Pay-if-Paid Subcontract Clauses?

Assuming the subcontract's pay-if-paid clause is enforceable, can a payment bond surety rely on the clause to defend against a subcontractor's payment claim? As the title above says – Sometimes a Defense, Sometimes Not.

In *Fixture Specialists, Inc. v. Global Construction, LLC*, 2009 WL 904031 (D. N.J. 2009), the federal district court applied New Jersey law to uphold the general contractor's defense against the subcontractor's payment claims based on the subcontract's pay-if-paid clause. When considering the defendant payment bond surety's reliance on the same clause, the court found no New Jersey law on point. Looking to New Jersey's surety law principles, the court noted "[t]he central theme imbedded in New Jersey's concept of suretyship is the surety's unique character – a surety's liability is triggered only when the principal's debt matures." 2009 WL 904031 at *10. Bearing in mind such principles, the court did not dismiss the surety's reliance on the clause, reasoning that if the pay-if-paid condition has not been met, the principal's (i.e. general contractor's) debt to the subcontractor has not matured and the payment bond surety is not obligated to pay on the bond until the principal's debt does mature.

The Supreme Court of Appeals of West Virginia utilized the same rationale to come to the same conclusion in the *Wellington Power Corporation* case. The court reasoned that as a result of the unfulfilled condition precedent of payment from the owner, "[i]t is plain that CNA cannot have

liability under the CNA bond, as Dick's surety, where Dick has no liability." 217 W.Va. at 41, 614 S.E.2d at 688.

In contrast are the Florida state court's ruling in *OBS Company, Inc. v. Pace Construction Corporation*, 558 So. 2d 404 (Fl. 1990) and the ruling of the U.S. Circuit Court of Appeals for the Fourth Circuit in *Moore Bros. Co. v. Brown & Root, Inc.*, 207 F.3d 717 (4th Cir. 2000). In both cases, and others, the courts reasoned that the unpaid subcontractors were not suing the surety under the subcontract, but rather pursuing their claims against the payment bonds which did not incorporate the pay-if-paid terms of the subcontracts, nor did the bonds in those cases otherwise hinge payment by the surety on the principal's (i.e. general contractor's) prior receipt of payment from the owner. Both courts included in their rationale the observation that to allow the payment bond sureties to rely on the owner's non-payment to the principal to prevent recovery under the bond would thwart the very purpose of the payment bond.

Conclusion

Given the differing enforcement of pay-if-paid clauses from state to state, why not include a favorable governing law provision in your subcontracts to control that risk? Good thought, but maybe not the control you think. In Maryland, a court invalidated a choice-of-law subcontract provision specifying another state's law to be governing on a project in Maryland when that other state law would have upheld the subcontractor's waiver of its mechanic's lien rights contrary to Maryland public policy. *National Glass, Inc. v. J.C. Penny Properties, Inc.*, 336 Md. 606, 650 A.2d 246 (1994). As another example, in New York, as of 2002, construction contract clauses making the contract subject to the laws of another state are void and unenforceable. N.Y. Gen. Business Law § 757.1.

In the end, if you choose not to modify the pay-if-paid terms in your subcontracts and trade contracts to match the controlling law, you will find the clauses to be sometimes a defense, sometimes a limited defense and sometimes no defense.

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