

Enforcing Conditional Payment Clauses

With the real estate market continuing to decline, subcontractors on troubled commercial and residential projects are finding out the hard way that they may not be able to recover payment from general contractors for their labor and materials.

While general contractors historically assumed the risk of an owner's nonpayment, many subcontracts now include payment clauses that condition payment to a subcontractor upon payment by an owner to the general contractor. General contractors are quick to rely on these clauses to excuse payment when the owner is insolvent or payment is significantly delayed.

However, these "pay-when-paid" or "pay-if-paid" clauses are not broadly enforceable, with some courts finding they violate state lien statutes and public policy.

Subcontractors should determine early on whether their subcontract contains a pay-when-paid or pay-if-paid clause to avoid any unpleasant surprises after they complete their work on a project. A typical pay-when-paid clause requires progress payments to be made to a subcontractor within a certain amount of days after payment is received from the owner. Pay-when-paid clauses generally have been interpreted as permitting a delay in payment by a general contractor only for a reasonable period of time. This language leaves the risk of the owner's nonpayment with the general contractor and

gives the subcontractor an unconditional promise of payment.

Pay-if-paid clauses, on the other hand, condition any payment to a subcontractor on the general contractor's receipt of full

payment from the owner. The subcontractor bears the full risk of collection in the event of nonpayment by the owner.

The hallmarks of a pay-if-paid clause are conditional language and absolutes that shift the risk of nonpayment to the subcontractor. For example, in March, the following payment clause was declared a pay-if-paid clause by a New Jersey district court:

"Subcontractor agrees that Contractor shall never be obligated to pay Subcontractor under any circumstances, unless and until funds are in hand received by Contractor in full... This is a condition precedent to any obligation of the Contractor, and shall not be construed as a time of payment clause..."

The court found this clause clearly shifted the risk of collection to the subcontractor and therefore did not operate as a time of payment, or a pay-when-paid, clause.

Pay-if-paid clauses are particularly problematic for subcontractors because a lack of a direct contractual relationship with the owner thwarts their efforts to take legal action. Moreover, the conditional language in the clauses can affect the traditional remedy for subcontractors trying to get paid: filing a mechanic's lien. A contractor's right to file a lien under many state lien laws is triggered by a "due and owing" requirement, and in pay-if-paid clauses, the subcontractor is not owed money until the general contractor receives payment from the owner.



REMEDIES FOR SUBCONTRACTORS

Pay-if-paid clauses are generally not favored by courts. Indeed, both New York and California have refused to enforce conditional payment clauses on public policy grounds due to concerns about their effect on mechanic's lien rights and the possibility that they may operate as illegal lien waivers. Other states, such as North Carolina and Wisconsin, have attempted to counteract the effects of pay-if-paid clauses through legislation that makes contingent payments in construction contracts against public policy.

Some states, such as Ohio, have enacted statutes ensuring the enforceability of a mechanic's lien regardless of the presence of a construction contract with a conditional payment clause. As such, subcontractors should be aware of the lien laws that govern their subcontract and vigilantly pursue their lien rights in all cases.

Subcontractors also may be able to look to a surety for payment on a payment bond. While the courts disagree on this issue, some state courts have held that a surety cannot rely on a pay-if-paid

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clause as a defense against payment. In the 2000 case *Moore Brothers Co. v. Brown & Root Inc.*, the court denied the surety the benefit of the pay-if-paid clause, persuaded by the fact that the payment bond did not contain a condition precedent to payment.

The pay-if-paid clause defense also may be unavailable to a surety defendant against subcontractor claims brought under the Miller Act, such as in the 2008 case *McKenney's, Inc. v. Government Technical Services, LLC*.

Subcontractors must become familiar with their payment rights under their subcontracts. They have no guarantees when it comes to conditional payment clauses, and the enforceability of such clauses depends on the language used in individual clauses, as well as the state law that governs the subcontract. When available, mechanic's liens remain the most reliable option for payment security.

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