

A Trap for the UNWARY:

Will a claim on a labor & material bond defeat a “pay if paid” clause in a contract?

By Jeff Blease & Bill J. Symes

A client, acting as the general contractor on a private project, is negotiating the terms of an owner-contractor agreement. The client uses subcontracts that contain a “pay if paid” clause which makes receipt of payment from the owner a condition precedent to any obligation to pay its subcontractors. The owner of the project now insists that the contractor post performance and labor and material bonds on the private project.¹ The client called to ask if posting performance and labor and material bonds for the project might defeat the “pay if paid” clause in the subcontracts and expose the contractor to claims by the subcontractors or the contractor’s surety for payment, even if the owner had not paid the contractor. The question raises sophisticated legal issues.

First, what is the distinction between a “pay if paid” and “pay when paid” clause? Second, when are “pay if paid” clauses in subcontracts enforceable, and in what states are “pay if paid” clauses prohibited? Third, how does the bond requirement change the analysis, if at all? Finally, what is the best way for a general contractor to limit its exposure to subcontractors if the owner does not pay, and conversely, what should a subcontractor look for in the contract documents to ensure that it is timely paid?

1. Distinction Between “Pay If Paid” And “Pay When Paid” Clauses

A “pay if paid” clause makes receipt of payment from the owner a condition precedent to any obligation for the contractor to pay its subcontractor. A “pay when paid” clause requires the contractor to pay the subcontractor within a reasonable time or a set number of days following receipt of payment from the owner. If the contract does not provide for a set number of days, courts will often impose a reasonable time for payment. Generally, a “pay when paid” clause does not allow a contractor to withhold payment from a subcontractor indefinitely,

even if it has not been paid by the owner. Thus, the critical distinction between the two clauses is that the “pay if paid” clause allows the contractor to withhold payment altogether if it has not been paid by the owner. With a “pay if paid” clause, the risk of owner nonpayment rests with the subcontractor.

2. Enforceability Of “Pay If Paid” Clauses

“Pay if paid” clauses are disfavored in many jurisdictions in the United States. Certain states ban them through legislation, while courts strike down the clauses in other states as against public policy.² The policy argument arises from an analysis of who has control over the financial safeguards for the project. The contractor has the direct relationship with the owner and is theoretically in the best position to guard against the risk of owner nonpayment. The subcontractor is viewed as an innocent third party who should not bear the risk of loss. The first question any contractor utilizing a “pay if paid” clause should be: Will the courts uphold the clause in the state where the project is located? The law in the state where the project is located may be entirely different than the law where the company home office is located.³ Currently, a true “pay if paid” clause may be enforceable in the majority of states, but it must be well drafted as it will be scrutinized by the courts.⁴ Even in states which allow the clauses, contractors should be wary of shifting sands in legal precedent and check with their lawyer before relying upon the enforceability of what is thought to be an enforceable “pay if paid” provision. Courts have sometimes refused to enforce purported “pay if paid” provisions, finding that the provisions failed to unequivocally express the parties’ intent to establish a condition precedent to payment. Ambiguous provisions are typically held to merely fix a reasonable time for payment rather than a condition precedent for payment.

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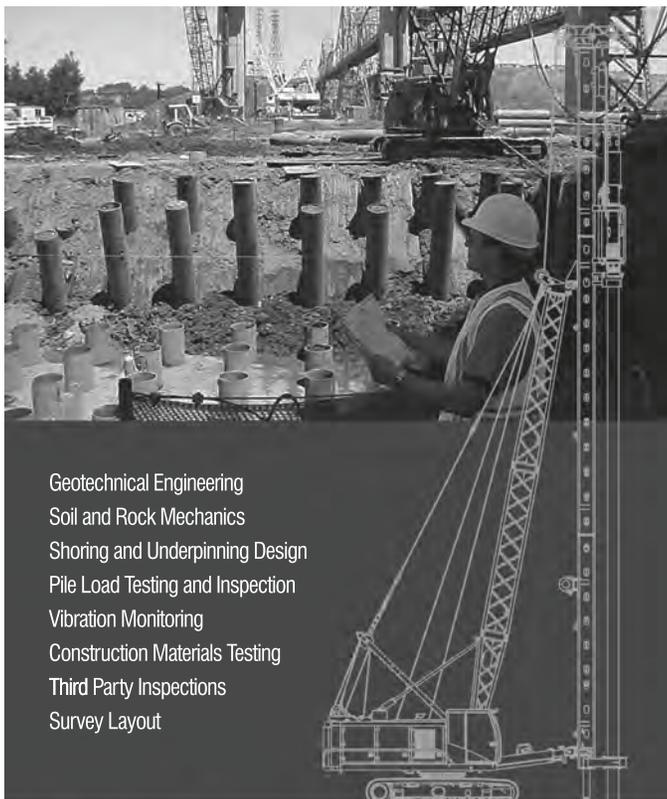
3. Effect Of A “Pay If Pay” Clause When The Contractor Posts A Bond

Assuming the project is located in a jurisdiction in which “pay if paid” clauses are enforceable, what happens when the owner requires the contractor to post performance and labor and material bonds? Arguably, posting the bonds may indeed defeat the protections of the “pay if paid” clause. The subcontractor will have a claim against the surety on the labor and material bond. Depending upon the jurisdiction, the surety may have to pay the subcontractor’s claim, regardless of the contractor’s use of an enforceable “pay if paid” provision.⁵ Although the surety generally has all of the rights and defenses of its principal (i.e., the contractor), statutory language or case law may limit the defenses available to the surety. In addition, the surety may be bound by legislation requiring it to promptly adjust claims under the bond. Of course, the contractor will have exposure to the surety under the parties’ general indemnity agreement, so even though the subcontractor may not be able to recover directly from the contractor, if the subcontractor recovers from the surety, the contractor will have to reimburse the surety under the general indemnity agreement. Therefore, although the contractor may not have to pay the subcontractor directly, it would have to reimburse the surety. Whether you are a contractor or subcontractor, you should seek the advice of your lawyer to assist you with the analysis of the interplay between a “pay if paid” clause and any performance or labor and material bonds posted to the project. A surprise later could be costly.

4. What Should Contractors And Subcontractors Consider When Confronted by “Pay If Paid” Clauses?

If you are a general contractor on the project, first make sure the “pay if paid” clause is well drafted and enforceable in the jurisdiction in which the project is located. Second, to the extent possible through negotiations, avoid posting bonds on the project. If a bond is required, be sure to incorporate any “pay if paid” clause into the language of the bond. Third, check the indemnity clause in the construction contract to make sure you have not agreed to defend, indemnify and hold the owner harmless from any and all liens, claims or damages asserted by subcontractors on the project. Finally, double check the special provisions, general conditions and any standard specifications for any language that requires the contractor to defend, indemnify and hold harmless the owner, architect or others from project claims. The law evolves over time and the best practice is to have the contract documents reviewed by your lawyer. Even standard forms should be reviewed at least on an annual basis.

Not surprisingly, a subcontractor should review the project documentation from the other side of the looking glass to eliminate the risk of owner nonpayment from the transaction. Check to see if there is a “pay if paid” clause in the contract documents. If so, is it enforceable in the jurisdiction where the project is located? If the contract documents have a “pay when paid” clause, does it limit receipt of payment to a reasonable time or a definitive time period? Try to negotiate a definitive time for which you are willing to wait for owner payment to



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the contractor before the contractor has an obligation to pay the subcontractor. Revise the language to make it clear that the risk of owner nonpayment is on the contractor if possible. Check to see if the contract documents require the posting of bonds for the project, and if so, check to see if you have a direct claim against the surety in your jurisdiction, unaffected by any “pay if paid” clause.

Contracts containing “pay if paid” and “pay when paid” clauses present sophisticated obstacles in the payment process. When a bond is required on the project, the situation is even more complicated. Checking with your lawyer before you sign a contract is the best way to avoid heartburn and heartache down the road whether you are a contractor or subcontractor on the project. ▼

1. A labor and material bond is sometimes referred to as a payment bond.
2. See, e.g., California, Delaware, Nevada, New York, North Carolina, South Carolina and Wisconsin. The law is less clear in states where the question has not been recently addressed.
3. A choice of law provision in the contract may alter the obligations of the parties, but that analysis is beyond the scope of this article.
4. The states in which “pay if paid” clauses are generally enforceable if well written include Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Virginia, Washington, and West Virginia.
5. For example, under Florida and Virginia law, courts have found a surety liable to a subcontractor even where the contractor utilized an enforceable “pay if paid” clause.



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