

CONTINGENT PAYMENT CLAUSES: Understanding your payment rights

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Depending upon the State where their work is performed, fire sprinkler subcontractors need to understand the payment terms in their subcontracts as it relates to the risk of non-payment from general contractors. Over time, general contractors have commonly added to their subcontract forms language which permits the general contractor to withhold payment from its subcontractors until such time that the general contractor has been paid by the owner. In other words, general contractors have attempted to shift the risk of non-payment by owners to the subcontractors who have performed the work. Usually these contract provisions are referred to as "pay-when-paid" or "pay-if-paid" clauses. Although they seem similar, there are differences between the provisions and most importantly, these clauses are interpreted differently depending upon the State law which governs the contract.

A "pay-when-paid" provision might appear as follows: "payment to the subcontractor shall be made no later than seven (7) days after receipt by the contractor of payment from the owner. If payment is not received by the contractor, through no fault of the subcontractor, contractor will make payment to the subcontractor within a reasonable time". Although payment to the subcontractor is based upon payment by the owner, if such payment does not occur, the contractor is still responsible for paying the subcontractor.

A "pay-if-paid" provisions might state this language: "Receipt of payment by the contractor from the owner is a condition precedent for payment by the contractor to the subcontractor. The subcontractor hereby acknowledges that it relies on the credit of the owner not the contractor, for payment of the subcontractor's work". This provisions makes payment by the project owner a condition precedent for payment to be made to the subcontractor.

Certain states have responded to these contract provisions with either legislative action or case law to weaken the impact of these contingent payment provisions. The California Supreme Court, for example, ruled in the case of *Wm. R. Clarke Corp. v. Safeco Ins. Co. of America* that "a general contractor's liability to a subcontractor for work performed may not be made contingent on the owner's payment to the general contractor". New York's highest court also struck down contingent payment clauses as violating public policy in the case of *West-Fair Elec. Contractors v. Aetna casualty & Surety Co.* Several other States, including Illinois, Wisconsin Maryland, Missouri and North Carolina

have passed legislation dealing with the enforceability of contingent payment clauses. These states have either held such clauses to be against public policy or have allowed subcontractors to maintain their lien rights notwithstanding such provisions. Throughout the United States there have been varied court decisions that have interpreted these provisions. Most of these case decisions have determined that a subcontractor should not be made a creditor of the owner unless there is clear and unequivocal evidence that the subcontractor assumed the risk of owner nonpayment.

Since the impact of upholding this type of language may be financially overwhelming for subcontractors who timely and properly perform their work, only to be denied payment due to insolvency of the owner, many courts have sought to interpret these payment clauses as requiring payment within a "reasonable time". The result has been for general contractors to therefore strengthen their contracts to add lengthy condition precedent type language to the contract to avoid any ambiguity on the risk of payment. In Virginia, for example, such a contract was upheld where the language was expressly written. *Galloway Corp. v. S.B. Ballard Construction Company*. Such a contract was also upheld in Michigan *Merkel & Co. Contractors vs. Christian Co.* It is for this reason that subcontractors must be diligent in reviewing their contracts to verify that the payment language does not contain "condition precedent" language.

There may still be ways to get around a "pay-if-paid" contract. Courts have been open to the argument that if the general contractor caused the non-payment by the owner, then the general contractor may have waived its right to rely on the condition precedent language. In other words, that the general contractor would have waived its right to stand behind the contract if it was their act that prevented payment in the first place. A general contractor will likely not be able to intentionally maintain a dispute with the project owner to avoid making payments to its subcontractors. Additionally, it may be that although there exists a condition precedent for payment by the general contractor, the subcontractor may not be prevented from pursuing its lien or bond rights against the project owner or surety. Some courts have found that it would be against public policy to deny a contractor both its lien and bond rights in addition to its contract rights by upholding such contingent payment language.

There is generally a split of authority by the courts and legislators concerning the issue of contingent payment language. For the subcontractor, it is essential that they approach their contracts fully aware of this issue and seek to negotiate

the language to "pay-when-paid" or reasonable time language rather than the alternative. If forced to accept "pay-if-paid" language subcontractors should attempt to obtain information about the owner's finances (or financing) prior to entering into the subcontract or should request that a payment bond be provided before starting their work. If possible, subcontractors should consider adding flow down "pay-if-paid" provisions with their materialmen or suppliers to protect themselves from having to pay downstream parties even if they do not receive payment for their work.

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