COURTS AND LEGISLATURES REVIEW CONDITIONAL PAYMENT CLAUSES

by

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I. INTRODUCTION

Most construction subcontracts contain conditions that the parties must satisfy before a general contractor's obligation to pay a subcontractor arises. Among other things, subcontracts often contain language conditioning the general contractor's payment obligations upon the general contractor's receipt of payment from the owner. For instance, a subcontractor may be faced with subcontract language which provides:

a. Payment to the subcontractor shall be made to the Subcontractor within seven (7) calendar days after receipt by the Contractor of payment from the Owner for such Subcontract Work;

b. Payment to subcontractor shall not become <u>due unless and until</u> Contractor receives payment for such Work from the Owner; or

c. Final Payment <u>shall not become</u> due <u>unless and until</u> the following <u>conditions precedent</u> to Final Payment have been satisfied; approval and acceptance of Subcontractor's Work by Owner, Architect and Contractor; and <u>receipt of Final Payment for Subcontractor's Work by Contractor from Owner.</u>

In an effort to shift the risk of owner nonpayment or owner insolvency to their subcontractors, general contractors have increasingly added conditional payment clauses, otherwise known as "pay-when-paid" clauses, to their subcontract forms. As a result, issues surrounding those clauses have recently become the focus of many court decisions.

II. GENERAL RULES REGARDING CONDITIONAL PAYMENT CLAUSES

In interpreting general, conditional payment clauses, such as those listed above, the courts have taken two approaches. A majority of courts have concluded that, unless the parties <u>explicitly and unambiguously</u> provide otherwise, a general contractor must pay a subcontractor within a "reasonable time" after the subcontractor completes the work, regardless of whether the owner has paid the general contractor for the work. Most importantly, unless explicitly provided, most courts have concluded that a general contractor typically bears the risk that an owner might become insolvent or that an owner may refuse to make one or more payments. Under that majority rule, a conditional payment clause, such as the clause listed in "a" above, does not create a

condition precedent to the general contractor's obligation to pay its subcontractors. Instead, the U.S. Court of Appeals for the Sixth Circuit, as well as other courts, have concluded that the clause merely establishes a time for payment and, even if the owner does not pay the general contractor, for reasons outside the subcontractor's control, the general contractor must still pay the subcontractor within a reasonable time after the subcontractor completes its work.[1]

A minority of courts has held that general conditional payment clauses, such as example "a" listed above, are ambiguous.[2] Therefore, those minority courts hold that they must consider extrinsic evidence in order to determine the parties' intent.

In light of the majority and minority rules set forth above, and in light of the recent influx of bankruptcies involving developers, general contractors have recently attempted to implement subcontract language that will effectively shift the risks of nonpayment to their subcontractors. They do so by adding explicit language, such as that found in examples "b" and "c" above, which must be satisfied before the general contractor's duty to the pay the subcontractor arises.

III. RECENT CASES IN WHICH COURTS HAVE ENFORCED THE CLAUSE

Across the country, many courts and legislatures have recently reviewed the enforceability of "pay-when-paid" clauses. For instance, the Maryland courts, in two related cases, referred to herein as the Gilbane Case[3], followed the majority rule.

In those cases, a general contractor entered into two separate subcontracts which provided: "it is specifically understood and agreed that the payment to the trade

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[1] That approach was first set forth in Thos. J. Dyer Co. v. Bishop Int'l Eng'g Co., 303 F.2d 655 (6th Cir. 1962). In that case, a general contractor refused to pay a subcontractor on a racetrack project because the owner had declared bankruptcy before it fully paid the general contractor. The subcontract provided: "the total price to be paid to the subcontractor shall be … $115,000.00 … no part of which shall be due until five days after owner shall have paid contractor therefor…." Id. at 656. When the subcontractor sued the general contractor for payment, the court refused to enforce the provision. The court noted that, normally, the general contractor bears the risk of owner insolvency, and that the parties could only vary the normal allocation of risks by implementing clear and unequivocal language to the contrary. Thus, it interpreted the clause as one which was designed to postpone payment for a reasonable period of time after the work was completed. See also Power & Pollution Services, Inc. v. Suburban Power Piping Corp., 74 Ohio App.3d 89, 598 N.E. 2d 69 (Ohio App. 8th Dist. 1991); Berkel & Co, Contractors v. Christman Co., 210 Mich. App. 416, 533 N.W.2d 838 (1995); DEC Electric, Inc. v. Raphael Constr. Corp., 558 So.2d 427 (Fla. 1990); Mrozik Constr. Inc. v. Lovering Assocs., Inc., 461 N.W. 2d 49 (Minn. App. 1990) (court reviewed a subcontract which provided that, "[f]inal payment including all retention becomes due and payable within 30 days after Architect's certification of final payment. At all times the subcontractor shall be paid to the extent that the Contractor has been paid on the Subcontractor's account," and concluded that the language of the subcontract at issue did not unequivocally shift the risk of the owner's insolvency to the subcontractor).

[2] See, e.g., St. Paul Fire & Marine Ins. V. Georgia Interstate Elec., 187 Ga. App. 579, 370 S.E.2d 829 (1988)

[3] Gilbane Bldg. Co. v. Brisk Waterproofing Co., 86 Md. App. 21, 585 A.2d 248 (1991); Architectural Systems, Inc. v. Gilbane Bldg. Co., 760 F. Supp. 79 (D. Md. 1991), sum. jmt granted, 779 F. Supp. 820 (D.Md. 1991), aff'd without op., 974 F.2d 1330 (4th Cir. 1992), reported in full, 1992 U.S. App. LEXIS 21242 (4th Cir. 1992).

contractor is dependent, as a condition precedent, upon the construction manager receiving contract payments, including retainer, from the owner."[4] During the course of construction, the owner ceased making payments to the general contractor, and the owner was ultimately forced into bankruptcy. In reliance on the subcontract conditional payment provisions, the general contractor refused to make progress and final payments to the subcontractors. The subcontractors sued the general contractor, one in state court and the other in federal court, seeking the outstanding monies. The courts ultimately held that the subcontracts clearly established that receipt of payment from the owner was a condition precedent to the general contractor's obligation to pay the subcontractors. The state court further explained that, regardless of whether the parties had discussed the possibility of the insolvency of the owner at the time they executed the contract, the contract clearly made the owner's payment a condition precedent to the general contractor's obligation to pay the subcontractor. The court added that the clause effectively transferred "from the general contractor to the subcontractor the credit risk of non-payment by the owner for any reason (at least for any reason other than the general contractor's own fault), including insolvency of the owner."[5]

The Virginia courts also recently reviewed a similar clause. However, unlike the Maryland courts, the Virginia Supreme Court did not simply follow the majority rule.[6] Rather it adopted a position that was somewhat a mixture of the majority and minority positions. The Virginia Supreme Court held that a general contractor, via a clear "pay-when-paid" clause in a subcontract, could shift the risk of the owner's default in payment from the general contractor to the subcontractors.[7]

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[4] Brisk, 86 Md. App. at 25,585 A.2d at 250; Architectural Systems, Inc., 760 F. Supp. at 80.

[5] 86 Md. App. at 28-29, 585 A.2d at 252 (Note: The Maryland court did not address how it would construe the conditional payment clauses in conjunction with mechanic's lien and/or payment bond law. However, as noted below, shortly following the decision, the Maryland General Assembly passed a statute which explicitly prohibits the enforcement of such clauses in relation to subcontractor mechanic's lien and payment bond claims.)

[6] Galloway Corp. v. S.B. Ballard Constr. Co., 250 Va. 493, 464 S.E.2d 349 (1995).

[7] The parties in the case had executed a preprinted AIA Subcontract which originally only provided that:

The Contractor shall pay the Subcontractor each progress payment within three working days **after the Contractor receives payment from the Owner**. If the Architect does not issue a Certificate of Payment or the Contractor does not receive payment for any cause that is not the fault of the Subcontractor, the Contractor shall pay the Subcontractor, on demand, a progress payment computed as provided in Paragraphs 11.7 and 11.8. (Emphasis in original).

and

Final payment, constituting the entire unpaid balance of the Subcontract Sum, shall be made by the Contractor to the Subcontractor when the Subcontractor's Work is fully performed in accordance with the requirements of the Contract Documents, the Architect has issued a Certificate of Payment covering the Subcontractor's completed work **and the Contractor has received payment from the Owner**. If, for any cause, which is not the fault of the Subcontractor, a Certificate for Payment is not issued or the Contractor does not receive timely payment, or does not pay the subcontractor within three working days after receipt of payment from the Owner, final payment to the Subcontractor shall be made upon demand. (Emphasis in original).

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However, the court concluded that the clause at issue did not convey a clear intent and contained a "latent ambiguity" as to whether the parties had contemplated that the owner might never pay the general contractor. The court held that, in the absence of a clear and unambiguous statement of the parties' intent as to the time of payment, an absolute "pay-when-paid" defense is available to a general contractor only if it can establish, by extrinsic evidence, that the parties mutually intended the contract to create such a defense. As a result, the court considered extrinsic evidence of the parties' intentions, and concluded that all but one subcontractor had contemplated the general contractor conditional payment defense and had thought it was avoiding the defense. Therefore, it reversed the trial court awards to all of the subcontractors, with the exception of that one subcontractor.

IV. COURTS MAY HOLD THAT THE CLAUSES ARE VOID EVEN WHEN THE LANGUAGE WOULD OTHERWISE BE ENFORCEABLE

Courts refuse to enforce conditional payment clauses for a variety of reasons that do not involve the actual language of the particular conditional payment clause. For example, courts may do so if there exists contrary statutory or contract language or if the general contractor hinders or interferes with the satisfaction of the condition precedent (owner payment).

A. Contrary Statutory Provisions and Public Policy

First, if there exist contrary statutory provisions, courts will not enforce the clauses. That is, some state legislatures have explicitly directed that such clauses are void and unenforceable.[8] Therefore, subcontractors and general contractors (and their sureties)

However, in each clause, the general contractor struck out all of the language following the word "Owner" and initialed the change. Thus, the subcontracts provided only that the general contractor "shall pay the Subcontractor each progress payment (continued . . . within three working days after the Contractor receives payment from the Owner," and that final payment would be made "when the Subcontractor's work is fully performed . . . , the Architect has issued a Certificate of Payment covering the Subcontractor's completed Work and the Contractor has received payment from the Owner."

[8] For example, Maryland Code Ann., Real Property § 9-113 (b) and (c) provide:

(b) Provisions conditioning payment to subcontractor on payment of contractor. – A provision in an executory contract between a contractor and a subcontractor that is related to construction, alteration, or repair of a building, structure, or improvement and that conditions payment to the subcontractor on receipt by the contractor of payment from the owner or any other third party may not abrogate or waive the right of the subcontractor to
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(1) Claim a mechanics' lien; or
(2) Sue on a contractor's bond.

(c) Void provisions. – Any provision of a contract made in violation of this section is void as against the public policy of this State. (1981, ch. 756; 1994, ch. 626; 1995, ch. 3 § 1.

should investigate whether the state, which governs their subcontract, has such a statute.

Second, courts refuse to enforce "pay-when-paid" and "pay-if-paid" clauses if they conclude that the clause in question conflicts with some statutory right and is therefore against public policy. For instance, courts might hold that the clauses are void as against public policy if they conflict with a subcontractor's mechanic's lien rights. In fact, recently, the Court of Appeals of New York (the state's highest court) ruled that a "pay-when-paid" provision in a construction subcontract violated the state's public policy and was therefore unenforceable.[9] In that case, because of the project owner's insolvency, the general contractor ceased making payments to the subcontractor. The subcontractor then sued the general contractor and its surety in federal court. The general contractor claimed that the "pay-when-paid" clause in the subcontract expressly stated that the subcontractor's right to payment would be "dependent, as a condition precedent" upon the general contractor receiving payment from the owner.

Once the case was brought on appeal, the New York Court of Appeals concluded that the words "condition precedent" in the clause at issue absolutely shifted the risk of the owner's failure to pay to the subcontractor. However, the Court examined the risk-shifting conditional payment provision, in light of Article 2, § 34 of New York's mechanic's lien law.[10] In light of that statute, the Court ruled that a conditional payment provision, which forces the subcontractor to assume the risk that the owner will fail to pay the general contractor, is void and unenforceable as contrary to public policy. The Court added, however, that "time-fixing" pay-when-paid provisions, which do not remove the basic right to payment, do not violate public policy and will continue to be enforced.[11]

B. Conflicting Contract Language

If the parties' contract contains language contrary to the "pay-when-paid" clause, courts will not enforce the clauses. For instance, in Premier Electrical Constr. Co. v. American National Bank of Chicago, 656 N.E. 2d 157 (Ill. App. 1 Dist. 1995), an electrical subcontractor filed mechanic's lien, payment bond and breach of contract claims for payment due. It argued that, under the terms of the contract, the time to pay could be

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[9] West-Fair Electric Contractors v. Aetna Casualty and Surety Co., 1995 N.Y. LEXIS 4448 (N.Y. 1995).

[10] The mechanic's lien law states, in pertinent part, that "any contract, agreement or understanding whereby the right to file or enforce any lien created . . . is waived, shall be void as against public policy and wholly unenforceable." (Emphasis added.)

[11] See also Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal. 4th 882, 64 Cal. Rptr. 2d 578, 938 P.2d 372 (1997), reh'g enied, 1997 Cal. LEXIS 5547 (1997) (the court concluded that pay-if-paid clauses are contrary to public policy and unenforceable because they amount to an impermissible, indirect waiver of a subcontractor's constitutionally-protected mechanic's lien rights which did not conform with the statutorily-permitted forms of mechanic's lien rights waivers).

delayed no longer than three months after the subcontractor completed its work. The general contractor claimed that it was not required to pay the subcontractor until it received payment from the owner (who had filed bankruptcy). The subcontract provided that, "if the subcontractor is making satisfactory progress with the work, is not in default and complies with all the documentation requirements of this Agreement, and if the General Contractor . . . has received payment from the owner for such Work, the General Contractor will make monthly payments to the Subcontractors . . .." However, the subcontract, in a dispute provision, also provided that "if a conflict arises between Owner and General Contractor . . . this subcontractor will receive payment in a timely manner just as if the conflict did not exist . . . ." The court determined that the "pay-when-paid" clause was superseded by the dispute clause. Therefore, the court concluded that, if language of a contract is clear and unambiguous and creates an exception to a "pay-when-paid" clause's enforceability, it would not enforce the conditional payment clause when the exception occurs.

Similarly, in OBS v. Pace Constr. Corp., 558 So.2d 440 (Fla. 1990), a drywall subcontractor sued a contractor and its payment bond surety for payment where the contractor had not been paid by the owner. The court reviewed the following language: "Final Payment shall not become due unless and until the following conditions precedent to final Payment have been satisfied: …(c) receipt of Final Payment for Subcontractor's work by Contractor from Owner…." In reviewing the case, the Supreme Court explained that there was nothing to prevent parties from shifting the risk of owner non-payment to the subcontractor. However, in order to make such a shift, the court explained that the contract must unambiguously express that intention. The court then went on to explain that because the clause referred to and sufficiently described the general contract, the court must review both the subcontract and the general contract.

As a result, the court concluded that the terms of the two agreements were inconsistent. The prime contract required that the general contractor pay its subcontractors before the owner would reimburse it. The subcontract, on the other hand, required that the general contractor pay the subcontractor only after receiving payment from the owner. The court concluded that the general contractor bears the burden of clear and unequivocal expression. When the court determines an ambiguity exists, it will construe the ambiguity against the general contractor. As a result, it interpreted the payment provision as establishing a reasonable time to pay rather than a condition precedent.[12]

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[12] The court added that even if the clause had effectively shifted the risk of owner insolvency or non-payment to the subcontractor, the clause would not affect the subcontractor's payment bond claim. Because the bond in this case was filed to replace the subcontractor's mechanic's lien rights, the clause could not affect the subcontract's rights. The court noted that to hold otherwise would "thwart the entire purpose and scheme of the mechanic's lien law and statutes allowing a bond in lien if exposure to liens."

C. Interference

Courts are also unlikely to enforce conditional payment provisions if the general contractor causes the owner non-payment or somehow prevents the payment.[13] Recently, a District of Columbia court refused to enforce a "pay-if-paid" clause, although the subcontract language at issue would likely have been otherwise enforceable.[14] In that case, a subcontractor hired a sub-subcontractor to install welded precast concrete on a project but failed to pay the sub-subcontractor for extra work, delays, disruption, attorneys' fees and interest. As a result, the sub-subcontractor filed suit for payment.

Although its sub-subcontract contained a conditional payment clause,[15] the sub-subcontractor argued that, prior to its filing suit, the general contractor had settled its claims with the general contractor. However, that settlement did not include the sub-subcontractor's claims, even though the subcontractor was contractually required to "pass-through" the claims to the general contractor. The court explained, first, that the condition precedent in the "pay-if-paid" clause was satisfied when the subcontractor settled its claims against the general contractor. The court added that, even if the settlement was not properly considered "payment" in satisfaction of the condition precedent, the subcontractor breached its sub-subcontract by failing to satisfy the implied duty to not frustrate the fulfillment of a condition precedent and by failing to protect the sub-subcontractor's interests in the settlement agreement. The court pointed out that, at the time of settlement, the subcontractor was aware of the sub-subcontractor's claim and of the "pay-if-paid" clause. The court concluded that the subcontractor could not benefit from its willful hindrance. Therefore, the court held the subcontractor liable for the breach and damages.

V. PAYMENT BOND SURETIES MAY HAVE DIFFICULTY RELYING UPON THE CLAUSES

Last, regardless of whether they rely on statutory language or public policy concerns, many courts have refused to permit payment bond sureties to rely upon conditional payment clauses. As a result, general contractors may be liable for payments to

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[13] See Bailey, supra, fn. 10.

[14] Urban Masonry Corp. v. N&N Contractors, Inc., 676 A.2d 26 (D.C. 1996)

[15] The clauses provided:

> 1(a) Payments will be made to the Subcontractor promptly as they are received. Receipt of payment by Contractor shall be a condition precedent to payment being owed to Subcontractor; and
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> 1(e) Invoices for work performed by Subcontractor will be paid within five (5) days after receipt of the corresponding payment from General Contractor. Contractor shall, however, have the right to withhold funds necessary to repair or complete defective work . . . . Late payments shall bear an interest at the rate of ten percent (10%) per annum . . . not beyond normal retention.

subcontractors by virtue of their duty to reimburse their payment bond sureties for payments made. For instance, courts will consider public policy in cases that involve Miller Act payment bond claims and state Little Miller Acts payment bond claims. That is, on public projects, although the law is not completely settled, courts are unlikely to preclude a subcontractor from maintaining a Miller Act payment bond suit as a result of a conditional payment clause.[16] For the most part, the courts have concluded that one of the very purposes of the statute is to protect subcontractors from non-payment. To enforce such a provision would fly in the face of that established purpose.

For example, a federal court recently reviewed the enforceability of conditional payment clauses in relation to private, "non-Miller Act" bond. In Moore Bros. Constr. Co. v. Brown & Root, Inc., No. 96-1809-A (E.D. Va. 1997), the court held that, even though the two subcontracts in question contained "pay-when-paid" clauses, the payment bond surety was required to pay two subcontractors outstanding monies due on their subcontracts. In that case, the subcontractors sued both the general contractor and its payment bond surety for outstanding monies earned as "early completion bonuses" and for additional work performed (previously awarded by an arbitration panel).

The surety argued that it was not required to pay the subcontractors because it was entitled to assert all defenses available to its principal, the general contractor, including the "pay-when-paid" defense. Alternatively, the surety argued that it was not required to pay the subcontractors because the claims at issue were not "sums due" under its bond. The bond in question contained typical language which provided, in part, that claimants may sue on the bond "for such sum or sums as may be justly due claimant, and have execution thereon." (Emphasis added). Based upon the language, it argued that

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[16] In United States for Use of Bailey v. United Pacific Ins. Co., 122 F. Supp. 48 (D.N.M. 1954), the court reviewed whether a subcontractor's payment bond claim was premature. In that case, the subcontract provided that, "no payment is due hereunder, whether a progress payment of final payment, until such progress or final payment has been made by the Government to the [General Contractor]." Also, the individual purchase orders provided that "final payment to be made upon receipt of final payment from U.S. Government by prime contractor." Because the general contractor had become insolvent and its surety had to complete the project, the government was withholding part of the full final payment. The court explained that the government's withholding of funds on a few items would not preclude the subcontractor's suit, because to do so would result in a complete forfeiture of the subcontractor's bond rights. Also, it added that, because the general contractor was responsible for the delayed payment to the general contractor, the surety could not rely on the condition precedent language. See also, United States Fidelity & Guaranty Co. v. Millers Met. Fire Ins. Co., 942 F.2d 946 (5th Cir. 1991), reh'g denied, 1991 U.S. App. LEXIS 26682 (5th Cir. 1991), (court explained [in a footnote] that "the pay-when-paid" clause in the Subcontract does not preclude (the Subcontractor's) recovery because, under the Miller Act, the liability of the contractor is to the subcontract, despite non-payment by the government to the contractor, and the federal legislation conditions payment of the subcontractor not in payment by the government to the contractor, but rather on the passage of time from completion of the work or provision of materials); United States for the Use of Ackerman v. Holloway Co., 126 F. Supp. 347 (D.N.M. 1954) (court explained that the Miller Act sets for the reasonable periods within which subcontractors must file statutory bond claims and that Congress did not intend for subcontractor to forfeit claims if the government does not pay the general contractor within that year; court concluded that the conditional payment provisions violated public policy and were therefore unenforceable). But see, Kasler Electric Co. v. Insurance Company of North America, 1989 WL 73214 (E.D. Mich. 1989) (court enforced a clear conditional payment provision because it noted that the surety should not be liable for the benefit that the Veterans Affairs Administration received when it had no assurance it would be successful in a suit against the VA; it added that the surety had not taken on that risk.)

because the owner had not yet paid the general contractor, the surety claimed the monies at issue in this suit were not "sums justly due" to the subcontractors.

The court, however, rejected the surety's arguments because the surety had not explicitly incorporated the terms and conditions of the subcontracts. The bond also did not include an explicit claim to the general contractor's defenses. The court stated, "[a]bsent such clear language or clear incorporation of the subcontracts, the surety cannot rely on the prime's defense for payment." The court concluded that the only conditions precedent for payment in the bond were the passage of 90 days and the principal's failure to pay. Because those conditions had been satisfied, and because the parties did not dispute that the work was completed or its value, the court held the surety must pay the subcontractors.

The court added that the surety's arguments ran counter to the very purpose of payment bonds in the construction field. That is, like Miller Act bonds, private payment bonds exist to ensure that subcontractors get paid if the general contractor fails to pay them for work and materials provided to the project at issue.

Likewise, in Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal. 4th 882, 64 Cal. Rptr. 2d 578, 938 P.2d 372 (1997) reh'g denied, 1997 Cal. LEXIS 5547 (1997), the Supreme Court of California held that the surety could not rely on the "pay-when-paid" clause in a subcontract in defense of a subcontractor's payment bond claim. California has a strong public policy in supporting the right to enforce mechanic's lien claims. First, California's Constitution establishes the right of persons furnishing labor and materials to a lien. Second, under California's mechanic's lien law, a subcontractor or supplier may only waive its right to enforce its lien by using one of the four forms required by statute. The surety argued that the "pay-when-paid" clause (which was not in one of the four prescribed forms) did not waive the subcontractor's mechanic's lien rights in that it "never acquired the contractual payment right that is a necessary pre-condition to the enforcement of any mechanic's lien remedy." With California's strong public policy in mind, the court rejected the surety's argument and held that, because the "pay-when-paid" clause was an improper waiver of mechanic's lien rights, it was invalid and unenforceable. Thus, the surety (and general contractor) could not rely upon the conditional payment clause in defense of the subcontractor's claims.

VI. CONCLUSION

In light of the above, subcontractors, general contractors and sureties should educate themselves regarding the enforceability of conditional payment clauses. Subcontractors who do not wish to bear the risk of owner non-payment and owner insolvency should not accept subcontract language that creates an enforceable condition precedent to payment. General contractors and sureties should likewise be cognizant of what language will be enforceable and what risks they may attempt to transfer to subcontractors. At the very least, sureties and general contractors should be sure to

explicitly incorporate their subcontracts, as well as all defenses available therein, into their payment bonds and performance bonds if they wish to effectively assert those clauses and defenses.

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