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THE PAY-IF-PAID CLAUSE AND DEFENSES TO ITS ENFORCEMENT



The “pay-if-paid” clause may be the most unforgiving contractual payment limitation confronting a subcontractor’s effort to receive timely payment for work properly performed. The pay-if-paid clause creates a *condition* that must occur before a general contractor is required to pay a subcontractor - simply that the general contractor is paid by the owner first. The consequences of a pay-if-paid clause are reflected in the several court decisions denying a subcontractor’s claim to hundreds of thousands of dollars for work properly performed because of a pay-if-paid clause and non-payment by the owner to the general contractor, which consequences may be so harsh as to bankrupt a subcontractor. Thus, in order to adequately protect themselves, diligent subcontractors should be able to identify a pay-if-paid clause and understand its limitations.

A typical pay-if-paid clause states: Contractor’s receipt of payment from the owner is a *condition precedent* to contractor’s obligation to make payment to the subcontractor.

Enforceable pay-if-paid clauses often include key words such as: *condition precedent*, *on condition that*, *if*, or *provided that*.

Without key words such as these, the conditional payment provision may only delay payment to the subcontractor for a reasonable time after work is performed, regardless of whether the owner pays the

general contractor.

The national trend is to identify conditional payment clauses that merely delay payment as “pay-when-paid” clauses. An example of a pay-when-paid clause is: [T]he Contractor shall pay each Subcontractor no later than seven days after receipt of payment from the owner.

Noticeably, there is a very fine distinction in the wording of a pay-if-paid clause versus a pay-when-paid clause. A diligent subcontractor should carefully review the conditional payment terms of the proposed subcontract and understand that the subtle wording of the clause may mean the difference between being paid within a reasonable time (pay-when-paid) and being paid at all (paid-if-paid).

THE ARGUMENTS OVER PAY-IF-PAID CLAUSES

There is a robust debate over pay-if-paid clauses because of their effect on subcontractors. An enforceable pay-if-paid clause shifts the credit risk of an owner from the general contractor to the subcontractor; may jeopardize the subcontractor’s lien or bond rights; and may prolong payment even if the owner has funds, such as where the owner withholds funds from the general contractor because of a dispute.

Opponents of the pay-if-paid clause argue that the clause should be unenforceable based on public policy. The public policy arguments include:

1. The general contractor’s direct dealings with the owner leave it best positioned to consider and investigate the solvency of an owner.
2. The general contractor, in a direct contract with the owner, has more control over ensuring payment is received.
3. The general contractor controls the entire project and can best resolve payment disputes with the owner.
4. The general contractor is better able to bear the risk of potential owner insolvency because, generally, subcontractors are smaller and more thinly capitalized.

The foremost argument in favor of the pay-if-paid clause is a bedrock principle of all contract law: Freedom to Contract. Proponents argue that the subcontractors may build the risk of non-payment into their bid price or simply refuse the work. Further, the pay-if-paid clause incentivizes each participant on the project to consider the risk of non-payment for itself. Proponents also argue that the pay-if-paid clause spreads the risk of non-payment rather than leaving the general contractor to bear it alone.

The pay-if-paid clause receives disparate treatment among the states. Courts in California and New York have refused to

enforce pay-if-paid provisions based on public policy. Massachusetts has limited enforceability of pay-if-paid clauses depending on the size of the project. Other states (North Carolina, South Carolina, Illinois, Maryland, Missouri and Wisconsin) have banned pay-if-paid clauses in all private projects regardless of the project's size.

MICHIGAN LAW

Under Michigan law, a properly drafted pay-if-paid clause is enforceable. In the governing 1995 case, the following pay-if-paid clause was enforced:

[A]ll payments to the subcontractor were to be made only from equivalent payments received by the general contractor for the work done, 'the receipt of such payments by [the general contractor] being a condition precedent to payments to the subcontractor.'

In that case, the Michigan Court of Appeals found that the clause clearly and

unambiguously shifted the risk of the owner's non-payment to the subcontractor. Thus, the subcontractor lacked a claim for payment until the owner paid the general contractor. Note that the clause contained the key words "condition precedent," which would signal to the informed subcontractor that the payment term included a pay-if-paid, not a pay-when-paid, clause.

DEFENSES TO THE PAY-IF-PAID CLAUSE

Even a properly drafted pay-if-paid clause has limitations. First, the general contractor may invoke the pay-if-paid clause only if it lacks fault for the owner's nonpayment. As discussed above, a pay-if-paid clause creates a *condition* that must occur before a subcontractor is entitled to payment - that the owner pays the general contractor. Under Michigan law, a party waives the condition if it prevents the condition from occurring, which may be by taking some action that causes non-payment from the

owner or by refusing to take action required under the contract.


No Michigan case defines when a general contractor's conduct waives a pay-if-paid clause. Expectedly, a general contractor may waive the pay-if-paid clause if it fails to persistently pursue payment from the owner, such as failing to properly invoice the owner for the subcontractor's work or suing the owner to collect the subcontractor's compensation. Further, if the owner's nonpayment is the result of a disagreement with the general contractor that is unrelated to the subcontractor, a court may find that the pay-if-paid clause was waived.

Recently, the Michigan Court of Appeals signaled another limitation to the pay-if-paid clause in the construction arena: The clause does not apply to work that falls "outside the parameters" of the subcontract. Last spring, the Court of Appeals decided a dispute between a subcontractor and its sub-subcontractor arising from the construction of a dining facility at Fort Sill in

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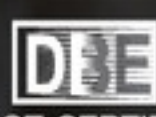
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Oklahoma. A plumbing and mechanical sub-subcontractor alleged that it was owed almost \$22,000 for base scope of work; \$172,049 for extra work triggered by errors in the project drawings; and \$347,786 because of a nine-month delay to its work. Among other things, the refusal to pay the sub-subcontractor was based on a pay-if-paid clause.

The Court of Appeals found that, based on the pay-if-paid clause, the sub-subcontractor could recover its balance for the base scope of work only after the subcontractor that hired it was paid by the general contractor. But absolute application of the pay-if-paid clause to the other claims was rejected. Instead, the pay-if-paid clause failed to govern work that fell "outside the parameters" of the sub-subcontract. The work related to the design errors fell "outside the parameters" of the sub-subcontract because related change orders were never executed. Further, if the delay was not contemplated by the parties at the time of executing the agreement, the Court of Appeals found that the delay would fall "outside the parameters" of the sub-subcontract and the pay-if-paid clause would not apply.

CONCLUSION

An enforceable pay-if-paid clause remains a formidable obstacle for any subcontractor. Like any challenge on a construction project, the pay-if-paid clause is best met by the prepared subcontractor. A diligent subcontractor should understand the differences between a pay-if-paid clause and a pay-when-paid clause; mitigate the risks of an enforceable pay-if-paid clause by investigating the solvency of an owner or building the risk of nonpayment into its bid; and know the clause's limitations, which may be summarized as:

1. If the general contractor fails to properly invoice the owner or diligently pursue the owner for non-payment, the clause may not apply.
2. If the non-payment is a result of a dispute between the owner and general contractor that is unrelated to the subcontractor, the clause may not apply.
3. If the uncompensated work fell outside the original scope of work and was not subject to a change order, the clause may not apply.
4. If there was delay that was outside the contemplation of the parties when the contract was executed, the clause may not apply to a claim for delay damages.

These limitations are often fact intensive and, unfortunately, Michigan law fails to recognize any bright-line rule. Further, based on the fierce, on-going debate over the enforcement of pay-if-paid clauses, all contractors are well served by consulting legal counsel to stay abreast of the current law. ☞

ABOUT THE AUTHOR

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