The Pay-If-Paid Clause and Chinks in its Armor

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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.[1] 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[2].

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.*[3] 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.[4]

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. [5]

Noticeably, there is a very fine distinction in the wording of a pay-if-paid clause versus a pay-when-paid clause. The distinction is complicated by lawyers and judges routinely using "pay-if-paid" and "pay-when-paid" interchangeably without recognizing the difference between the two clauses. A diligent subcontractor should, however, 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 and being paid at all.

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. These consequences can severely impact the subcontractor. For example, a general contractor did not have to compensate its drywall subcontractor $348,155 for work performed because the owner was insolvent and the subcontract had a pay-if-paid clause.[6] In similar circumstances, a precast concrete subcontractor that had substantially completed its work without any payment lost $885,507.[7]

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 has more control over ensuring payment is received because it has the contract with the owner.
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, which are commonly sophisticated business entities, may build the risk of nonpayment 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 nonpayment for itself. Proponents also argue that the pay-if-paid clause spreads the risk of nonpayment rather than leaving the general contractor to bear it alone.

The pay-if-paid clause receives disparate treatment among the states, which may be a reflection that both sides of the argument have validity. Courts in California and New York have refused to enforce pay-if-paid provisions based on public policy.[8] Through legislative action, Massachusetts has limited enforceability of pay-if-paid clauses depending on the size of the project; and 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.[9] And several other states have yet to rule upon the enforceability of the pay-if-paid clause.

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.'[10]

In that case, the Michigan Court of Appeals found that the clause clearly and unambiguously shifted the risk of the owner's nonpayment to the subcontractor. Thus, the subcontractor lacked a claim for the payment until the general contractor was paid by the owner. Note that the clause contained the key words "condition precedent,"

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which would signal to the informed subcontractor that the conditional payment term was a pay-if-paid clause rather than a pay-when-paid clause.

Limitations of 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.[11] A party "may prevent the condition from occurring by either taking some affirmative action, or by refusing to take action required under the contract … ."[12]

There is no Michigan case law that 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, which may be properly invoicing 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, the pay-if-paid clause is likely waived. Indeed, other jurisdictions have found that a pay-if-paid clause is waived where the owner's refusal to pay was due to disputes between the owner and general contractor.[13]

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. In April 2015, the Court of Appeals decided a dispute between a subcontractor and its subsubcontractor arising from the construction of a dining facility at Fort Sill in Oklahoma.[14] LaSalle Group was the subcontractor and had hired Macomb Mechanical to complete plumbing and mechanical work. Macomb Mechanical 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, LaSalle Group defended on the basis of a pay-if-paid clause.

The Court of Appeals found that Macomb Mechanical could recover its balance for the base scope of work only after LaSalle Group was paid. But absolute application of the pay-if-paid clause to Macomb Mechanical's other claims was rejected. Instead, the pay-if-paid clause failed to govern work that fell "outside the parameters" of the subsubcontract. The work related to the design errors fell "outside the parameters" of the sub-subcontract because LaSalle Group never executed related change orders. Likewise, 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 subsubcontract—and the pay-if-paid clause would not apply.[15]

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 (1) understand the differ-

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ences between a pay-if-paid clause and a pay-when-paid clause; (2) 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 (3) know the clause's limitations. Plus, 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.

1 According to a survey conducted by the American Subcontractors Association, "pay-if-paid clauses were identified as a very serious problem by 67.9% of those surveyed." And "[a]nother 22.1% viewed the issue as being somewhat serious." 6 Bruner & O'Connor Construction Law § 19:57 (May 2015).

2 Pay-if-paid clauses may be used at all levels of the contracting tiers (i.e. between a subcontractor and a sub-subcontractor). For simplicity, this article uses the general contractor-subcontractor relationship.

3 William M. Hill & Mary-Beth McCormack, Pay-If-Paid Clauses: Freedom of Contract or Protecting the Subcontractor from Itself? 31 The Constr. Lawyer 1, 2 (Winter 2011).

4 For example, in *Thos. J. Dyer Co. v. Bishop Intern. Engineering Co.*, 303 F.2d 655 (6th Cir. 1962), the court found that the conditional payment clause ("no part of [the payment due subcontractor] shall be due until (5) days after owner shall have paid contractor therefor") was meant to merely "postpone payment for a reasonable period of time after the work was completed, during which the general contractor would be afforded the opportunity of procuring from the owner the funds necessary to pay the subcontractor.")

5 American Institute of Architects, AIA Document A201 § 9.6.2 (2007).

6 *Architectural Systems, Inc. v. Gilbane Bldg. Co.,* 760 F. Supp. 79, 82 (D. Md. 1991).

7 *Universal Concrete Products Corp. v. Turner Constr. Co.,* 595 F. 3d 527, 529 (4th Cir. 2010).

8 Hill & McCormack, *supra* n. 3, 31 The Constr. Lawyer at 2.

9 *Id.* at 3.

10 *Berkel & Co. Contractors v. Christman Co.,* 201 Mich. App. 416, 418-19; 533 N.W.2d 838 (1995).

11 *Harbor Park Mkt., Inc. v. Gronda,* 277 Mich. App. 126, 131; 743 N.W. 2d 585 (2007).

12 *Id.*

13 *D.K. Meyer Corp. v. Bevco, Inc.,* 206 Neb. 318; 292 N.W.2d (1980); *Grady v. S.E. Gustafson Const. Co.,* 251 Iowa 1242; 103 N.W.2d 737 (1960); *Culligan Corp. v. Transamerica Ins. Co.,* 580 F.2d 251 (7th Cir. 1978); *Eastern Heavy Constructors, Inc. v. Fox,* 231 Md. 15; 188 A.2d 286 (1963).

14 *Macomb Mechanical, Inc. v. LaSalle Group,* Inc., et al., Docket No. 319357 (Mich. Ct. App. April 23, 2015)(unpublished).

15 The Court of Appeals also found that the pay-if-paid clause was waived if LaSalle's actions or interference caused the unreasonable delay.

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