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Sixth District Court of Appeals Sets High Hurdle for Enforcing "Pay-if-Paid" Subcontract Clause

by Matthew D. Harper

In the recent case of *Transtar Electric, Inc. v. A.E.M. Electric Services Corp*., the Ohio Court of Appeals for the Sixth Appellate District addressed the enforceability of "pay-if-paid" clauses in construction subcontracts. (The Sixth Appellate District includes Erie, Fulton, Huron, Lucas, Ottawa, Sandusky, Williams and Wood Counties. A decision in this Court is binding precedent on all courts within these eight counties.) The Court's ruling sets a high hurdle to draft an enforceable pay-if-paid clause and merits the attention of Northwest Ohio contractors using such clauses.

Generally in the construction industry, a general contractor bears the risk of non-payment by the owner of a project. However, some construction subcontracts contain specific clauses – commonly known as pay-if-paid clauses – which are intended to shift the risk of non-payment by the owner from the general contractor to the subcontractor. A typical pay-if-paid clause might state:

> Payments will be made monthly as the work progresses for the value of the completed work as determined by the Contractor, Owner, and Architect. Invoices from the Subcontractor for progress billings must be in our hands by the 25th day of the month and will be paid:
>
> a. Terms: *Payments from the Owner to General Contractor are a **condition precedent** to General Contractor's payment to Subcontractor*.

Thus, a pay-if-paid clause ties the obligation to pay the subcontractor to ***whether*** the owner pays the general contractor; a subcontractor only gets paid ***if*** the general contractor gets paid first.

Because of the potentially severe results of such a risk-shifting provision, Ohio courts have long required precise contract language to make clear the parties intended such a result. As summarized by the Ohio Court of Appeals for the Tenth Appellate District in *Evans, Mechwart, Hambleton & Tilton, Inc. v. Triad Architects, Ltd*:

> Payment provisions qualify as pay-if-paid provisions if they expressly state: (1) payment to the contractor is a condition precedent to payment to the subcontractor . . . , (2) the subcontractor is to bear the risk of the owner's nonpayment . . . **or** (3) the subcontractor is to be paid exclusively out of a fund the sole source of which is the owner's payment to the subcontractor. (Emphasis added.)

Under *Evans, Mechwart*, a contract clause which met any of the three options would be deemed sufficiently clear as to the parties' intent and, hence, enforceable. In *Power & Pollution Services, Inc. v. Suburban Piping Corp*., the Ohio Court of Appeals for the Eighth Appellate District found the critical distinction to be whether the clause "set a condition precedent to the general contractor's duty to pay the subcontractor . . . . "

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The Sixth District's decision takes a narrower approach to determining the enforceability of such a clause. In *Transtar*, a hotel owner hired the general contractor to build a swimming pool. The general contractor hired the subcontractor to perform the necessary electrical work for the swimming pool. The subcontract stated:

> (c) The Contractor shall pay to the Subcontractor the amount due only upon the satisfaction of all four of the following conditions: (i) the Subcontractor has completed all of the Work covered by the payment in a timely and workmanlike manner, * * * (ii) the Owner has approved the Work, * * * (iii) the Subcontractor proves to the Contractor's sole satisfaction that the Project is free and clear from all liens * * * and (iv) the Contractor has received payment from the Owner for the Work performed by Subcontractor. **RECEIPT OF PAYMENT BY CONTRACTOR FROM OWNER FOR WORK PERFORMED BY SUBCONTRACTOR IS A CONDITION PRECEDENT TO PAYMENT BY CONTRACTOR TO SUBCONTRACTOR FOR THAT WORK.** (Emphasis original.)

The hotel owner failed to pay the general contractor in full and the general contractor therefore did not pay the subcontractor in full. The subcontractor sued the general contractor which defended based on the pay-if-paid clause of the subcontract.

While the trial court held the subcontract clause was an enforceable pay-if-paid clause because it stated that payment by the owner was a "condition precedent" to payment by the contractor, the Court of Appeals reversed. In so holding, the Court of Appeals rejected the three-tiered test articulated in *Evans, Mechwart* in favor of a much stricter test. Specifically, the Court of Appeals stated:

> In our view, the language in the *Evans, Mechwart* case goes beyond what was necessary to resolve that case and beyond the position Ohio courts have used to resolve whether a contract provision is pay-if-paid or pay-when-paid. Going back to *Dyer*, Ohio courts have held that, if a contract provision is to be construed as a pay-if-paid clause, the language must clearly and unambiguously indicate that the intent of the parties was to shift the risk of payment from the general contractor to the subcontractor. The sine qua non of such a provision is a clear unambiguous statement that the subcontractor will not be paid if the owner does not pay.
>
> The *Evans, Mechwart* case, quoting a federal case, suggests that the provision may state that it is a condition precedent or a shift of risk. In our view, this is insufficient. It must be made plain, in plain language, that a subcontractor must ultimately look to the owner of the project for payment. While the words "condition precedent" may be helpful, the term is not sufficiently defined to impart that both parties understand that the provision alters a fundamental custom between a general contractor and a subcontractor. Consequently, ***absent language making manifest the intent to shift risk of payment, the provision must be construed as a pay-when-paid clause.*** (Emphasis added.)

Based on its articulated standard, the Court found that the subcontract's payment clause was not enforceable as a pay-if-paid clause and provided no defense to the subcontractor's claim.

The Court's decision does not specifically state what language would be sufficient to "manifest the intent to shift risk of payment" and create an enforceable pay-if-paid clause; however, it does state that the language used by the general contractor in *Transtar* was insufficient. Many of the existing subcontracts containing pay-if-paid clauses use language very similar to that at issue in *Transtar*. In light of the Sixth Appellate District's determination that such language is insufficient, general contractors using such clauses would be well-advised to have legal counsel review their subcontracts to determine if any revisions are in order to meet the standard adopted in *Transtar*.

For more information on pay-if-paid clauses and construction law in general, please contact Mr. Harper in our Toledo office.

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