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Shifting the Risk: The Enforceability of Contingent Payment Clauses

by Amy J. Borman and Matthew D. Harper

Every construction contract carries the risk that the property owner will not pay for the work performed. In larger projects, the general contractor traditionally bears that risk, not the subcontractors. However, subcontractors should be aware that their construction contract could contain a "contingent payment clause" that shifts the risk of non-payment down to the subcontractor. This article discusses these clauses and their enforceability.

A contingent payment clause can take two basic forms: a "pay-when-paid" or a "pay-if-paid" clause. The first does not shift the risk of non-payment to the subcontractor, but the second does exactly that. Each is explored further below.

First, a typical "pay-when-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:

About the photo: Associate Patrick A. Sadowski at our new Findlay office.

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a. Terms: *Payment upon receipt of funds from the Owner.*

Under a pay-when-paid clause, payment is tied to ***when*** an upper-level contractor gets paid, but courts do not interpret these clauses to shift entirely the risk of nonpayment to lower-level contractors. Thus, a pay-when-paid clause still embraces the traditional view that the general contractor bears the risk of non-payment by an owner.

In *Thomas J. Dyer Company v. Bishop International Engineering Company*, the Sixth Circuit Court of Appeals created the payment procedure to be followed when a contract contains a pay-when-paid clause. The case concerned a general contractor who refused to pay his sub-contractors after the owner declared bankruptcy because the contract stated that the general contractor only had to pay his subcontractors "when" he was paid. The Court disagreed and held that a pay-when-paid clause contains an unconditional promise to pay. The Court held that an upper-level contractor still bears the risk of non-payment and that a pay-when-paid clause only postpones payment. Under *Dyer*, payment to subcontractors must occur either (1) when a general contractor gets paid, or (2) after a reasonable period of time.

Second, 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.*

A pay-if-paid clause is tied to *whether* an upper-level contractor receives payment from the owner. As drafted, the pay-if-paid clause means a subcontractor only gets paid if the contractor gets paid. Because of the potentially severe results of such a shift, courts require very precise contract language making clear the parties intended such a result. Specifically, both Ohio and Michigan courts require a clear statement that payment by the owner is a "condition precedent" to the general contractor's duty to pay the subcontractor. If there is any confusion as to the intent of the parties, courts will interpret the provision as pay-when-paid and keep the risk of payment with the upper-level contractor.

Equity and freedom of contract are the two competing policies governing the interpretation and enforcement of pay-if-paid clauses. Under traditional notions of equity, the general contractor should bear the financial risk of non-payment because he or she is in direct privity of contract with the owner. Presumably, the general contractor has better knowledge of whether the owner might not be able to pay and will be in a better position to resolve any disputes that might result in the owner's refusal to pay. Moreover, the general contractor is often more financially able to bear non-payment than subcontractors who may be smaller and less equipped to bear the risk of an insolvent owner.

Conversely, public policy also favors the freedom of contract, particularly in the commercial setting. Under this notion, if a subcontractor freely enters into a contract, it should be enforced on its terms. The courts' strict requirement of precise language to enforce a pay-if-paid clause balances these competing policies.

While contingent payment clauses are enforceable under both Ohio and Michigan law, a pay-if-paid clause will not interfere with a subcontractor's ability to seek other legal remedies against the general contractor. For example, under the Michigan Builder's Trust Fund Act (MBTFA), a general contractor is required to pay its subcontractors before it pays itself. Therefore, if a general contractor pays subcontractors on the basis of percentage of work completed, including making payments to itself, and then fails to pay the subcontractors upon completion, the subcontractors can bring a claim under the MBTFA for recoupment of the progress payments made by the general contractor to itself.

The bottom line is that subcontractors must pay attention to contract language to make sure they know exactly what risk they are assuming. For more information on contingent payment clauses, please contact Amy J. Borman in our Columbus office (614-564-1445) or Matthew D. Harper in our Toledo office (419-241-6000).

Amy J. Borman is a member of the Firm and located primarily in our Columbus office. She has significant experience in advising clients on compliance with emerging legislative and statutory issues in the areas of education and business law.

Mr. Harper is a member of the Firm. He represents owners, contractors, subcontractors and suppliers in complex, multi-party commercial construction disputes. He also provides representation to parties involved in residential projects as well as clients in disputes involving real estate, land use, and zoning and eminent domain. In addition, Mr. Harper advises clients regarding mechanic's liens.

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