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BY SCOTT G. WOLFE

PAYMENT DISPUTES & CONTINGENT CLAUSES: *What Happens Next?*



GCs and subcontractors often examine contingent payment clauses up close only *after* an issue arises. But what if a payment dispute arises and a pay-if-paid clause is in place? How can GCs and subcontractors best position themselves?

This article focuses on what parties can do when arguing these clauses, and analyzes the precarious and convoluted legal position surrounding these disputes – from the perspectives of both the top and bottom of the contracting chain.

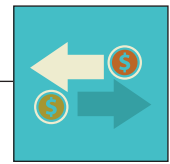
PAYMENT PROVISIONS IN THE CURRENT CONSTRUCTION MARKET

Contingent payment clauses, such as pay-when-paid or pay-if-paid clauses, are present within nearly every construction contract throughout the U.S. These provisions have evolved over time to become more sophisticated, exacting, and onerous.

Susan McGreevy's article "Pay-If-Paid Clauses: How You Can Protect Your Company" (May/June 2013) explores these clauses' evolution in-depth. The pay-when-paid clause began appearing within construction contracts around the early- to mid-1960s, and was introduced by GCs to shift financial risk of a project down the contracting chain. After interpretations of the pay-when-paid provision began universally favoring subcontractors, it was modified and transformed into a stricter pay-if-paid variety.¹

These days, high stakes and complicated financial risk-shifting devices are built into nearly every construction contract. As a result of our recent economic experience, drafting and negotiating contracts to insulate parties from financial risks are likely to become more popular.

Debate over the effect of contingent payment clauses, therefore, may be at least a small part of most payment disputes. Let's examine how both the GC and subcontractor can best position themselves when engaged in a contingent payment provision battle.



THE GC'S PERSPECTIVE

A popular adage derived from an old Scottish expression presents great news for GCs in the contingent payment provision battle: "Possession is 9/10ths of the law."²

While the expression is not actually rooted in legal jurisprudence, the practical message is clear and substantially close to the truth. When a GC and subcontractor battle over payment, the GC often starts with better leverage and a better position. Even when the GC is on the wrong side of the law, the subcontractor may have to spend significant time, money, and frustration in proving its case.

Therefore, irrespective of the remaining discussion in this section, the GC engages in the contingent payment provision battle with a better starting position. Here is some guidance to help GCs maintain that position.

Don't Let Greed Take Over

Withholding payment from a subcontractor and relying on a clearly written contingent payment provision as justification will allow the GC a lot of negotiation room, but, given the delicacy of the GC's position, being too greedy could quickly cause a change in fortune.

The "possession is 9/10ths of the law" adage certainly creates leverage, but if GCs don't pay close attention to their legal position, they risk reversing the leverage, or perhaps worse, throwing the parties into a legal gray area.

As we'll later explore, pay-if-paid provisions are not exactly built on a strong bedrock of clear and predictable case law. The contractual clause may appear clear-cut, and the jurisdiction may be favorable to GCs, but as McGreevy explained in her analysis of pay-if-paid case law across America, even those "courts in states that don't prohibit pay-if-paid clauses go out of their way to find a chink in what the contractor intended to be an ironclad clause."³

In the contingent payment provision battle, every position is a delicate one.

Understand Varying & Changing State Laws

When interpreting contingent payment provisions, states will generally fall into one of four categories: 1) They will enforce pay-if-paid provisions strictly; 2) They will invalidate pay-if-paid provisions consistently; 3) They will have a mix of these two consequences; or 4) They simply will not have any historical case law on the issue.

However, the devil is always in the details, and there are two particular details that can burn a GC.

First, construction contracts vary significantly from document to document. Contract document collections (e.g., AIA Contract Documents and ConsensusDocs) are popular in the industry and normalize the variances to a degree, but they still contain negotiated provisions unique to the parties. Further, when a document set is not used, the provisions are almost always unique.

Case law on contingent payment provisions turns entirely on the exact terminology of the provision. In fact, in almost every jurisdiction that will enforce a pay-if-paid provision, the courts require the provision to be explicit and unambiguous. See, for example, case law in Oregon, where pay-if-paid provisions are enforceable only if they contain "clear and unambiguous language...expressing the intention that the happening of a contingency over which the [subcontractor] has no control shall be a condition precedent to payment."⁴

A state may have case law favorable to pay-if-paid provisions, but a judge could skirt around that and distinguish a specific provision from the previously ruled-upon provision.

Second, the law on pay-if-paid clauses is new, convoluted, and most importantly, unsettled. In many instances, state courts have ruled upon the issue at a trial or appellate level only, which leaves room for overturning precedent at the state's supreme or highest court. In other instances, courts may simply overrule previous decisions on the issue. State legislatures may also pass laws impacting these provisions while contracts are ongoing.

The pay-if-paid provision presents a very well matched battle between America's belief in the "freedom of contract" and its belief that subcontractors, laborers, and lower-tiered parties on construction projects should be paid. Courts and legislatures around the country are still working on the balance between these two principles. GCs should be cautious about finding themselves in this legal landmine.

If You're Right, You're Right

This article highlights the perils of getting deep into a fight over contingent payment provisions, but there are situations where the GC will simply be right. For this to occur, the following must be present:

- The project is in a state that favors pay-if-paid provisions;
- The contract language is standard and is an exact match

or substantially similar to contract language previously construed by the state's court;

- The property owner must have actually withheld payment to the GC related to the subcontractor's work;
- The subcontractor must be without lien or bond claim rights;
- The subcontractor must be without other legal arguments, such as unjust enrichment claims; and
- The judge assigned to the case must be fair and firm.

If all of these circumstances are present, the ultimate risk of loss is relatively low and leverage will heavily favor the GC. In these situations, it may be worthwhile for a GC to stick to its guns and let the subcontractor make its moves to seek payment.

Nevertheless, it's Litigation 101 to never foreclose on the idea that a settlement with the subcontractor may be the best business decision. GCs should use the leverage of their situation to broker a better deal.

THE SUBCONTRACTOR'S PERSPECTIVE

While the good news for GCs is that "possession is 9/10ths of the law," subcontractors have good news as well: The odds that they could *eventually* beat the GC in a contingent payment provision battle are very good. (It just may be very, very expensive.)

Pay-When-Paid Clauses

Pay-when-paid provisions have been almost universally reduced to a benign timing mechanism for payment. In other words, these provisions never eliminate the subcontractor's ultimate right to payment. Instead, they regulate when the payment is due. If payment up the chain never manifests itself, GCs are required to pay subcontractors within a "reasonable time." As a result, anything interpreted as a pay-when-paid provision will result in a favorable litigation outcome for the subcontractor.

Many GCs (and their attorneys) may not know about this limitation of pay-when-paid provisions. Therefore, subcontractors shouldn't be surprised if they receive a legal letter denying payment rights based on a pay-when-paid provision. Ultimately, however, the subcontractor typically wins this argument.

Pay-If-Paid Provisions

Contingent payment provisions of the pay-if-paid variety are much more complicated. Nevertheless, subcontractors

confronted with these provisions are likely in a good legal situation.

First, the provision may be invalid as a matter of public policy. This is the case in jurisdictions such as California, Delaware, Nevada, and New York. These states, among others, have statutes that specifically outlaw the enforceability of these clauses.

Second, the provision may be "enforceable," but only under certain conditions. In these situations, the state's courts will review a pay-if-paid provision very strictly to verify that its intention to shift the risk upon the subcontractor is clear and unambiguous.

Third, in those instances where the law is unclear, subcontractors will have a compelling argument that the provision is against the state's public policy.

When confronted with a contingent payment provision dispute, subcontractors ought to analyze the applicable law and determine how the provision will be interpreted. The better the law for the subcontractor, the more the subcontractor can push back against the GC's position.

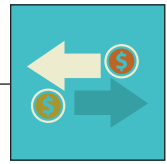
Lien & Bond Claim Rights

The intersection of mechanics lien and bond claim rights with contingent payment provision jurisprudence is almost completely unaddressed by courts across the country. For subcontractors, the odds seem good that future decisions will fall in their favor.

Unlike contingent payment provisions, mechanics lien and bond claim laws have existed as a cornerstone of American construction law for more than 220 years.⁵ These laws enable subcontractors to go outside their specific contract to claim collateral against the project jobsite itself, or a payment bond claim. By their very nature, therefore, the mechanics lien and bond claim remedies are extra-contractual, and further, exist for the explicit purpose of insulating subcontractors from the financial risk pushed upon them by contingent payment provisions.

Contingent payment provisions, on the other hand, are intra-contract agreements between two specific parties (the GC and the subcontractor, in most instances). Signing a contract with a contingent payment provision means the subcontractor is agreeing *with* the GC to not be entitled to a contractual payment if payment doesn't flow down the chain.

Agreeing to these provisions is not an agreement to waive mechanics lien or bond claim rights. In fact, if a court were



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to interpret a contingent payment provision as a waiver of lien rights, it would likely create a crack in the law. That's because only three states (Virginia, Colorado, and Nebraska) allow such lien right waivers, and another 20 states explicitly prohibit such waivers.⁶ If a pay-if-paid provision is to be interpreted as valid, therefore, it must likely be simultaneously interpreted as *not* a waiver of the subcontractor's underlying lien rights.

Of course, this likely leaves the subcontractor with the right to file a mechanics lien or bond claim, even in the face of being legally unable to recover for the same work contractually. In many states, the law specifically prohibits pay-if-paid provisions from negatively impacting a subcontractor's lien rights.

Contingent payment provisions are gaining popularity. Furthermore, owners and GCs are making the terms more explicit. While the law is good for subcontractors in many jurisdictions, it is unfavorable or unclear in others.

A subcontractor's best weapon in the contingent payment provision battle is to preserve and hold onto mechanics lien and bond claim rights.

Unjust Enrichment Arguments

Unjust enrichment, or enrichment without cause, is the common law theory that a "quasi-contract" is created between two parties that do not otherwise have a contract if, in the interest of justice and fairness, compensation is warranted. The legal theory is only accessible to parties under certain conditions.

The construction project presents a unique case for the unjust enrichment argument. For a subcontractor, an actual contract exists between it and the GC, but a contract does not exist between it and the property owner.

According to the unjust enrichment concept, the subcontractor could argue that the owner was "unjustly enriched" by the subcontractor's work or materials, and therefore, even though an actual contract did not exist between them, a quasi-contract could be created by the courts in the interest of justice and fairness.

Although this argument sounds good, it rarely works in construction litigation because a party cannot qualify for an "unjust enrichment" argument unless the enrichment is "unfair." The courts do not consider circumstances "unfair" when the subcontractor can recover under a contract with a GC, and a property owner already has obligations to pay a GC.

Contingent payment provisions, however, may be able to invert these equity considerations under some circumstances. For example, if a GC is not legally obligated to pay a subcontractor because payment hasn't been received from the owner, then the owner has not incurred an injustice by needing to pay twice, and the subcontractor does not have a "fair" remedy in hand because there is no obligation for the GC to pay.

Unjust enrichment arguments are always legal long shots, but nevertheless, subcontractors should keep this remedy in mind when fighting for payment against contingent payment provisions.

CONCLUSION

The war of financial risk-shifting is ongoing in the U.S. construction industry, and much of the battle is being fought over contingent payment provisions. These provisions, however, are new, evolving, and subject to unsettled and convoluted law.

The best option for GCs and subcontractors is to intelligently negotiate these provisions at the start of a project. However, even long negotiations can result in an agreed-upon clause with lots of ambiguities or legal risk.

If a payment dispute comes down the pipe, GCs will be in a better position to assert practical leverage, but the subcontractors may have a better or more open-ended legal argument. Furthermore, if the subcontractor leverages its lien rights, it may be able to avoid the controversy and seek payment directly from the owner.

All in all, contingent payment provisions are a murky area of law, and any dispute, regardless of each party's position, will likely be expensive, long, and unpredictable. ■

Endnotes

1. McGreevy, Susan L. "Pay-If-Paid Clauses: How You Can Protect Your Company," *CFMA Building Profits* May/June 2013.
2. Martin, Albert M. "Answers." *The Chautauquan* (Chautauqua Literary and Scientific Circle) Vol. 3 (October 1882).
3. McGreevy, Susan L. "Pay-If-Paid Clauses: How You Can Protect Your Company," *CFMA Building Profits* May/June 2013.
4. *Mignot v. Parkhill*, 391 P.2d 755 (Or. 1964).
5. Rockel, William M. *A Treatise on the Law of Mechanics' Liens*, The Bobbs-Merrill Company, 1909.
6. Wolfe, Scott. "Who Lets You Waive Your Lien Rights Before Payment: A State By State Analysis," November 14, 2013.

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More on Mechanics Lien Laws

It is interesting to consider the differences in state mechanics lien laws. Some states allow a subcontractor to lien for the "value of the improvement to the property" and other states allow the lien for the "contract value" of the work. In the former case, the value of the lien is completely detached from the underlying contractual obligation, and therefore, it's a relatively easy argument to separate the lien obligation (based on improvement value) from the lien obligation (based on a contract value, which may be zero in a pay-if-paid situation).

For example, compare the mechanics lien law in California, which allows a lien for the "value of the work" (California Civil Code §8430), with the mechanics lien law in Louisiana, which allows a lien for the "price of the work" (Louisiana R.S. 9:4801, 9:4802). Theoretical problems are presented when a pay-if-paid provision is enforceable, lien rights are not waivable by contract, and a lien right arises from the contract obligation and not the value of improvements to the land.

Maryland Code Real Property § 9-113(b) is a prime example of legislation that specifically prohibits pay-if-paid provisions from negatively impacting a subcontractor's lien rights. The code provides that "A provision [is void as against the public policy of the State] 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: (1) Claim a mechanics' lien; or (2) Sue on a contractor's bond." Similar provisions exist in Illinois, Indiana, Kansas, and Ohio.