Understanding contingent payment provisions

A look at pay-when-paid, pay-if-paid, and payment clauses. **by Scott Wolfe Jr.**

Pay-when-paid, pay-if-paid, and similar payment provisions are likely some of the most controversial clauses within a construction contract. Worse, these provisions are routinely relied upon by contractors and owners engaged in payment disputes to hold back money (and therefore, maintain leverage) from subcontractors and suppliers. With so much money and time hinging on these provisions, it's unfortunate that most companies don't fully understand them.

To understand how these payment provisions will be interpreted within a specific contract, it's important to understand why "contingent payment provisions"—commonly referred to as "pay-if-paid" and "pay-when-paid" clauses—exist.

Financial risk—the risk of losing money—is one of the many risks managed by the parties on every construction project. Lenders and property owners lay a lot of money on the line developing a particular project, and must mitigate the risk that extra money leaks through the cracks as it is passed down the contracting chain. Those at the top of the chain can't afford to pay suppliers and low-tier subcontractors twice simply because a general contractor or subcontractor misappropriated money or messed up managing the project.

It may come as a surprise to find that the United States' general policy is that those at the bottom of the chain should not carry this financial risk burden. When it comes to getting paid, in other words, U.S. policy dictates that the lower tiered parties should always get paid for their work and that the higher tiered parties (GC, owner, lender) should carry the risk of possible non-payment. Consider lien laws, misappropriation of funds criminal penalties, payment timing penalty provisions, and more.

In response to all of the laws that insulate subcontractors and suppliers from the financial risk, those at the top of the chain have used the "freedom of contract" principles to shift the financial risk back down the chain through

Clauses	Effects
Clause A: AIA A201 9.6.2: The contractor shall promptly pay each subcontractor, upon receipt of payment from the owner, out of the amount paid to the contractor on account of such subcontractor's portion of the work, the amount to which said subcontractor is entitled.	**Effect A:** The contractor is only obligated to pay the subcontractor if payment is received from the owner, and payment is due only after such is received. If payment is never received from the owner, the contractor need not ever pay the subcontractor.
Clause B: AGC 655 8.2.5: Receipt of payment by the contractor from the owner for the subcontract work is a condition precedent to payment by the contractor to the subcontractor. The subcontractor hereby acknowledges that it relies on the credit of the owner, not the contractor, for payment of subcontract work.	**Effect B:** The contractor is obligated to pay the subcontractor if and when payment is received from the owner, but if payment is never made, the contractor must pay the subcontractor within some reasonable time.
Clause C: Custom Contract Provision Ex: Payment will be made not more than thirty (30) days after the submission date or ten (10) days after the certification or when we have been paid by the owner, whichever is later.	**Effect C:** The contractor must pay the subcontractor whenever the subcontractor completes their portion of work, and makes an application for payment, regardless of any payment from the owner.
Clause D: AGC 650 8.2.5: Progress payments to the subcontractor shall be made no later than seven (7) days after receipt by the contractor of payment from the owner. If payment from the owner is not received the contractor will make payment to the subcontractor within a reasonable time.	**Effect D:** The contractor must pay the subcontractor within 30 days after submission of an application for payment.

Match the different contingent payment clauses to their possible effect in the chart below, then go to page xx to see how you did.

agreement. Thus, pay-when-paid and pay-if-paid provisions were invented and pushed into every construction contract across America.

These provisions are responses to the laws protecting subcontractors and suppliers. They have morphed over time from "progress payment" schedules, to pay-when-paid clauses, to more restrictive pay-if-paid clauses—and they usually fail at actually shifting the project's financial risk and invalidating the protective laws in place for those at the bottom of the contracting chain.

Take a moment to match the different contingent payment clauses to their possible effect in the chart below, then go to page xx to see how you did and read more about what a contingent payment provision within a contract really means. ■

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CLAUSE & EFFECT: HOW DID YOU DO?

In most instances, all of the clauses would be interpreted the same (effect B), except in a minority of states that will enforce them exactly as written.

Pay-when-paid and pay-if-paid provisions come in a variety of shapes and sizes, but when rubber meets the road, they are usually dismissed by courts as mere timing mechanics or altogether invalid.

In the chart, clauses A, C, and D are all pay-when-paid clauses. These clauses require payment "when" or "after" payment is received from up the contracting chain. They are distinguished from the more restrictive "pay-if-paid" clause, which is demonstrated by clause B, in that they do not contain language clarifying that payment is only required "if" payment is received.

The difference between the word "when" and "if" is very important. For years, the pay-if-paid clause did not exist, and instead, all contracts simply were written with pay-when-paid clauses. When courts were called upon to interpret the effect of these clauses, however, it determined that "when" is not the same as "if," and accordingly, interpreted the provisions as a mere timing mechanics.

The promise to pay-when-paid, in other words, simply acted to give the parties a framework of when payment would be due. If payment was never received, however, the contractor was required to pay the subcontractor within a reasonable time. The timing provision, in other words, did not act to shift the risk of non-payment down the chain.

While there are exceptions, this is how a majority of courts interpret this provision.

After courts began to write off pay when paid provisions as timing mechanisms, contractors, developers, and lenders went back to their financial risk shifting tool chest and, with their attorneys, invented the pay-if-paid provision.

This provision, as can be seen in the chart's clause B, answers the court's objections very clearly: It underscores that payment is only due if payment is received, it states that such payment is a condition precedent to payment being due down the chain, and it even goes so far as to affirmatively state that financial risk of non-payment from the owner is being shifted down the chain.

While there are exceptions, many courts have looked or are looking at this provision and dismissing it as invalid and against public policy.

What does the contingent payment provision within a contract mean? That is a difficult legal and practical question answer.

Legally speaking, the above discussion about how contingent payment provision are interpreted is a broad stroke approach to a very nuanced debate. There are many states that have not weighed in on the debate (Alaska, Arkansas, Kentucky, Maine, Minnesota, New Hampshire, North Dakota, Rhode Island, South Dakota, and Wyoming), and there are many states who explicitly allow restrictive contingent payment provisions (Virginia, Oklahoma, New Jersey, Iowa, Arizona, Connecticut, and Ohio).

Practically speaking, the lack of understanding or lack of legal clarity on these clauses leads parties into costly fights with unknown endings. Often, judges and lawyers will not truly understand the effect of these provisions. The battle here is between the freedom of contract and the interests in protecting lower tiered construction participants against non-payment.

Different jurisdictions weigh the interests of one over the other differently, and too often the result of this difficult battle is a convoluted mess of case law, statutes, and practical application.

The best advice for companies? Get the wording in your contract as close to something you can live with...and if you get in a dispute, hold on. ■