

Pay-When-Paid Clause in Subcontract Cannot Be a Condition Precedent to Payment

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In New York, any clause in a construction contract (including subcontracts) that seeks to make payment from the project owner a condition precedent to payment from the general contractor to the subcontractor is void and unenforceable. These “pay-if-paid” clauses cannot shift the risk of an owner’s nonpayment from a general contractor to a subcontractor. Accordingly, courts continually strike “pay-if-paid” clauses.

To get around this prohibition, many general contractors include “pay-when-paid” clauses in subcontracts that seek to regulate the timing of payments to subcontractors. Meaning, a general contractor will pay the subcontractor within a date certain of the general contractor’s receipt of payment from the owner for the subcontractor’s work. General contractors, however, cannot use a “pay-when-paid” clause to act as a condition precedent, converting the clause into a “pay-if-paid” clause.

In a recent case, a subcontractor brought suit against the general contractor after it had not been paid for the electrical contracting services and materials furnished within its subcontract scope of work, including approved extras. One of the general contractor’s main reasons for not making payment to its subcontractor was that the owner had not paid the general contractor, therefore payment was not due under the “pay-when-paid” clause of the parties subcontract agreement.

Essentially, after nine months of performing work on a project, a dispute arose between the general contractor and the owner and the general contractor and its subcontractors, including the electrical subcontractor, ceased performing work. When negotiations to resolve the dispute with the owner failed, the general contractor filed a mechanic’s lien, which included amounts owed to its subcontractors, including the electrical subcontractor. The owner ultimately obtained and filed a bond to discharge the mechanic’s lien.

After the electrical subcontractor commenced the action against the general contractor, the electrical subcontractor moved for summary judgment seeking its subcontract balance. In opposition to the motion, the general contractor alleged that there were questions as to the sufficiency of the electrical subcontractor’s work and stated that there was no present obligation to make full payment because the general contractor had not received full payment from the owner for the electrical subcontractor’s work.

Based upon the general contractor’s defense to the motion, the court began its inquiry into the policy behind “pay-if-paid” clauses. The court noted that suppliers and small contractors on large construction projects need reasonably prompt payment for their work and materials in order for them to remain solvent. Based upon this backdrop, “pay-when-paid” provisions that effectively serve as a condition precedent to a general contractor’s

duty to perform (pay-if-paid) is void and unenforceable as contrary to public policy. The court further noted that it is generally presumed that parties to a construction contract do not intend payment to the small subcontractors to await a determination of an extended legal dispute between the owner and general contractor over an issue not concerning the subcontractor's work.

While the subcontract payment clause required the general contractor to make progress payment to the electrical subcontractor within 15 days of receiving the corresponding payment from the owner and within 30 days for final payment, the subcontract stated, "the parties acknowledge that this is a 'pay when paid' timing mechanism, and not a 'pay if paid' provision." The court, in interpreting this clause, held that the parties' "pay-when-paid" clause merely regulated the time for payment. The court further held that the general contractor's argument that payment was not due was unavailing because the general contractor could not utilize this clause in such a way that it effectively acted as a condition precedent to its obligation to pay, thereby shifting the risk of the owner's nonpayment from the general contractor to the subcontractor. While this provision provides for a postponement of payment to permit the general contractor to obtain funds from the owner, the court held that payment may only be delayed for a reasonable time after completion of the subcontractor's work.

Here, the court noted that the subcontractor completed its portion of the work on the project over two years prior to the motion that was before the court. Therefore, the court held that a period exceeding two years is an unreasonable period of time to withhold payment and that the general contractor cannot further resist payment of the remaining balance, notwithstanding the owner's non-payment.

Commentary

"Pay-when-paid" clauses cannot be used as a condition precedent, shifting the burden of the owner's non-payment from a general contractor to a subcontractor. Here, the court held that a subcontractor waiting over two years for payment was unreasonable and improperly converted the subcontract's "pay-when paid" clause into an impermissible "pay-if-paid" clause.

As explained by this recent case, the general contractor's obligation to pay its subcontractors is independent of the general contractor's receipt of payment from the owner for such work. While in the ideal situation, the owner will timely pay the general contractor and the general contractor will then pay the subcontractor, this often times does not happen.

All general contractors and subcontractors who have sub-subcontractors should be mindful that they are obligated to pay the downstream contractors regardless of whether they receive payment from the owner or general contractor. Payment, however, may be withheld for a reasonable amount of time, in the hope that the owner makes the required payment.

Feel free to call me to discuss obtaining payment on New York construction projects.