

## Real Estate Title Insurance & Construction Law

### The Enforceability of Pay-if-Paid and Pay-When-Paid Clauses in Subcontracts

By Meghan B. Barrett

In the current economic climate, many New Jersey subcontractors are finding themselves struggling to get paid for their work due to owner insolvency. Often caught off-guard and therefore stymied by the automatic stay provisions of the bankruptcy courts from filing a lien against the owner's land, subcontractors find themselves looking exclusively to the general contractor or the construction manager for payment. Many subcontracts, however, condition payment to a subcontractor upon payment by an owner to the general contractor. These "pay-if-paid" clauses are increasingly common in trade subcontracts, and general contractors will look to them to excuse payment in these situations. However, these clauses are not broadly enforceable, and practitioners representing contractors on both sides of the issue need to be aware of the cur-

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rent case law on the subject, with the key inquiry being which party assumes the risk of collection from the owner.

In *Seal Tite Corp. v. Ehret, Inc.*, 589 F. Supp 701 (D.N.J. 1994), an oft-cited case from the District Court for the District of New Jersey, the general contractor refused to pay the subcontractor for its work, claiming that a payment clause in the subcontract only required it to pay the subcontractor if it had been paid in full by the owner. Judge Fischer rejected the general contractor's position, holding that the payment clause at issue was not a conditional promise to pay (a "pay-if-paid" clause), but rather operated as a "pay-when-paid" clause which allowed a general contractor to postpone payment to a subcontractor for a reasonable period of time while it secured the necessary funds from an owner. The District Court relied heavily on an opinion issued by the Sixth Circuit, *Thos. J. Dyer Co. v. Bishop Int'l Engineering Co.*, 303 F.2d 606 (6<sup>th</sup> Cir. 1962), which presented a similar factual situation, noting with approval the Sixth Circuit's reasoning that it is a generally accepted premise

that in construction contracts, the risk of an insolvent owner is and should be borne by a general contractor, absent a clear manifestation of intent to transfer that risk to the subcontractor. Judge Fischer found this clear manifestation of an intent to transfer the risk lacking in the *Seal-Tite* contract. The Appellate Division reached a similar conclusion in an unpublished decision, *Avon Bros., Inc. v. Tom Martin Construction Co., Inc.*, No. 740-99T1, 2000 WL 34241102 (App. Div. 2000), where it adopted the *Seal-Tite* reasoning, and rejected an attempt by a general contractor to avoid paying its subcontractor under a "pay-when-paid" clause. The Appellate Division saw no evidence of intent to shift the risk of owner insolvency to the subcontractor, and held that the payment clause at issue merely permitted a reasonable postponement of the general contractor's payment obligation.

As the *Avon* case noted, the key inquiry for a court examining "pay-if-paid" or "pay-when-paid" clauses is not the use of "when" or "if" in the payment clause, but rather whether there is clear evidence of an intent to "shift the risk

of collection.” The holdings in *Seal Tite* and *Avon Bros.* therefore make clear that general contractors seeking a valid pay-if-paid defense must make sure to explicitly transfer the risk of an owner’s nonpayment to the subcontractors. The District Court had the occasion to consider one of these risk-shifting clauses in *Fixture Specialists, Inc. v. Global Construction, LLC.*, No. 07-5614, 2009 WL 904031 (D.N.J. March 30, 2009). The subcontract at issue in *Fixture Specialists* contained the following payment clause, which the general contractor argued created a condition precedent to the subcontractor’s right to receive payment:

Subcontractor agrees that Contractor shall never be obligated to pay Subcontractor under any circumstances, unless and until funds are in hand received by Contractor in full...This is a condition precedent to any obligation of the Contractor, and shall not be construed as a time of payment clause...

The District Court agreed with the general contractor’s interpretation of the clause as a “pay-if-paid” clause, persuaded by such phrases as “never be obligated to pay” and “under any circumstances,” and held that the payment clause clearly shifted the risk of collection to the subcontractor, and operated as more than a time of payment provision.

When bankruptcy automatic stay provisions are not a roadblock, subcontractors seeking to lien the project to protect their

right to payment will often argue that a “pay-if-paid” clause violates the anti-lien waiver provisions of the New Jersey Construction Lien Law, which provides that “waivers of construction lien rights are against public policy, unlawful and void.” N.J.S.A. 2A:44A-38. Indeed, courts in other states, including New York and California, have invalidated pay-if-paid clauses on these public policy grounds. See, e.g., *West-Fair Electric Contractors v. Aetna Cas. & Sur. Co.*, 661 N.E.2d 967 (N.Y. 1995); *WM. R. Clark Corp. v. Safeco Ins. Co. of America*, 938 P.2d 372 (Cal. 1997). These holdings are based on a public policy argument that a “pay-if-paid” clause has the effect of negating the “due and owing” requirement necessary to trigger the subcontractor’s right to file a lien under most state lien laws. (Note that N.J.S.A. 2A:44A-8 requires a lien claimant to certify that payment is due and owing.) In other words, if the general contractor has no obligation to pay the subcontractor, the subcontractor’s payment is not “due and owing.” However, so far, New Jersey courts have been reluctant to embrace this line of reasoning. In the aforementioned *Avon* case, the Appellate Division did not directly address the issue, as it had already concluded that the clause at issue was a “pay-when-paid” clause. But it did cast doubt on the argument, relying on a Supreme Court decision, *Thomas Group v. Wharton Sr. Housing*, 163 N.J. 507 (2000). In *Thomas*, the Supreme Court rejected such a narrow reading of the “due and owing” requirement and found that substantial performance of a contractor’s obligations was sufficient to permit it to file a lien for work that had been completed, even if a contractor had not satisfied all of its contractual prerequisites to payment. However, its right to enforce the lien may

be stayed.

The District Court, in *Fixture Specialists*, relying on *Thomas*, directly rejected this argument, holding that the anti-waiver provision in New Jersey’s lien law does not invalidate risk-shifting payment clauses. Also, although New Jersey courts have yet to address the issue, the *Fixture Specialists* Court, based upon a survey of out-of-state cases and general contract principles, held that a surety may also rely upon a “pay-if-paid” clause as a defense against a demand for payment from a subcontractor on the grounds that payment has not accrued. Note, however, that this holding may not extend to a surety defending against subcontractor claims brought under the Miller Act. See, e.g., *McKenney’s, Inc. v. Government Technical Services, LLC*, 531 F.Supp.2d 1375 (N.D.Ga.2008).

In sum, the effectiveness of a “pay-if-paid” or “pay-when-paid” clause will depend upon the language used in the clause itself. A clause that merely states that payment will be made upon the contractor’s payment by the owner will probably not rise to the level of a “pay-if-paid” clause so as to act as a defense to a contractor’s payment obligations. However, a clause that clearly transfers the risk of nonpayment to the subcontractor, by way of explicit, risk-shifting language, is likely to be interpreted as a valid defense to payment. Further, recent case law suggests that “pay-if-paid” clauses do not violate the anti-waiver provisions of the New Jersey Lien Law and are not void as against public policy. Faced with an enforceable “pay if paid” clause, subcontractors and suppliers should be vigilant in pursuing their lien rights. Those lien rights may be their only form of payment security. ■