

# Contingent Payment Clauses: How to Make Them Viable

By Christopher S. Drewry

Many standard subcontracts contain what in construction parlance is referred to as a contingent payment clause, which provides that a subcontractor's payment from a general contractor (GC) is contingent upon the GC's receipt of payment from the owner. Under such a clause, if the owner does not pay the GC, then payment is not due or owing to the subcontractor.

From the GC's perspective, the need to make such payments conditional or contingent upon being first paid by the owner is obvious. The GC does not want to end up being the involuntary financing agent for the project if for some reason the owner delays payment to the GC or withholds payment altogether, especially if the reasons for that withholding are not the fault of the GC. In other words, the GC does not want to get "gapped" where it would find itself in the position of not being paid by the owner but having to front the money to pay the subcontractor. From the subcontractor's perspective, the subcontractor may not want to risk not being paid due to a contractual relationship upstream to which it is not a party.

Despite being in virtually every GC's standard subcontract form, there remains uncertainty in the construction industry as to the effectiveness of the clause.

## DISTINGUISHING BETWEEN CLAUSES

The typical contingent payment provision is one of two types, either (a) that payment will not be made until payment is received from the



owner ("pay-when-paid") or (b) that the obligation for payment will not arise at all unless payment is made by the owner ("pay-if-paid"). The latter type of clause is a true contingent payment clause, making performance of a contractual precondition by the owner the predicate for the contractor's obligation to pay the subcontractor.

With regard to pay-if-paid clauses, a number of jurisdictions have upheld such provisions where the contract between the contractor and the subcontractor contains an express condition clearly showing that it is the intention of the parties that payment to the contractor is a condition precedent to the subcontractor's right to payment. Courts have upheld these clauses where the parties expressly contemplate shifting the burden of forfeiture under a subcontract to the subcontractor by promising payment only *if* the primary contractor is paid. Although not universally recognized and enforced, clauses that clearly state the intent to make owner payment a condition precedent (i.e., that constitute a pay-if-paid clause) have been routinely

held to be adequate to transfer the risk of non-payment by the owner to the subcontractor. Other courts believe that it is not the use of "when" or "if" that is dispositive on the enforceability of the clause, but whether there is clear evidence of an intent by both parties to shift the risk of collection. To be enforceable as a pay-if-paid clause, a majority of the courts that have ruled that the term "condition precedent" actually must be used in the clause itself.

As for pay-when-paid clauses, contingent payment clauses in many other jurisdictions have been interpreted to not represent a condition precedent which excuses payment altogether, but rather constitute a covenant to pay within a reasonable time. In these jurisdictions, the courts have held that the contingent payment clause did not create a condition precedent for payment, but established the time and means of payment. In other words, it is a way of deferring the subcontractor's payment for a reasonable length of time, but is not an ultimate bar to recovery.

## ABOUT THE AUTHOR

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## THE PREVENTION DOCTRINE DEFENSE

One possible obstacle to the enforceability of a contingent payment clause—be it a pay-if-paid or pay-when-paid provision—is the subcontractor's defense based upon the prevention doctrine. This doctrine is a generally recognized principle of contract law which provides that if one party prevents or hinders fulfillment of a condition to the other's performance, the condition may be waived or excused. The prevention doctrine does not require proof that the condition would have occurred but for the wrongful conduct of the one party. Rather, it only requires that the party's conduct materially contributed to the non-occurrence of the condition.

Under the prevention doctrine, a GC may not be able to avoid its payment obligations to a subcontractor simply by relying upon a contingent payment clause when the very reasons for that nonpayment by the owner were due to the actions or fault of the GC. In other words, when the GC contributes or prevents the non-occurrence of the condition precedent (in this case payment by the owner), then the GC cannot subsequently rely upon that contingency not occurring as a defense to its failure to pay.

In jurisdictions which follow the prevention doctrine, a party cannot rely upon the failure of a condition precedent if that party is responsible for hindering the occurrence of the condition. Thus, parties are required to use reasonable effort to bring about the occurrence of the condition precedent, and they have an implied duty to not do anything to injure the other party's right to enjoy the benefits of the contract.

## CONCLUSION

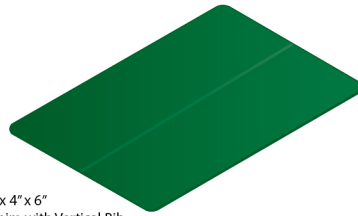
Practically speaking, GCs can effectively allocate the risk associated with payment to its subcontractors through the use of contingent payment clauses. With the proper language, one's exposure can be drastically reduced through conditions or contingencies which must first occur prior to payment. However, it is critical that GCs are aware of how these clauses are enforced within their respective jurisdictions. Also, in order for a contingent payment clause to be enforceable, it is important that GCs are not responsible for hindering the occurrence of a condition precedent to payment so that subcontractors cannot argue for the application of the prevention doctrine. ■



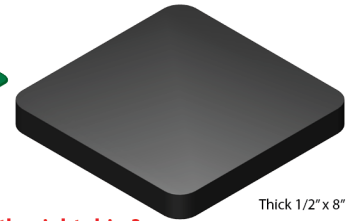
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