A recent decision from one state’s high court has clarified, simplified, and furthered the objectives of consistency and predictability in this unsettled area of law, and, hopefully, courts in other jurisdictions have done, or will do, likewise.

Construction contacts between general contractors and subcontractors often contain one of two types of contingent payment provisions known as a “pay-when-paid” clause or a “pay-if-paid” clause. A “pay-when-paid” clause governs the timing within which a general contractor must remit payment to its subcontractor, linking the general contractor’s receipt of payment from the owner to the general contractor’s payment to the subcontractor. Under this type of provision, the general contractor must make payment to the subcontractor within a reasonable time, even if the general contractor does not receive payment from the owner.

The more restrictive “pay-if-paid” clause, however, does not govern the timing of a general contractor’s payment obligation, but rather dictates whether such payment obligations exist at all. Where there is a valid “pay-if-paid” provision in the contract, the general contractor is only required to pay the subcontractor if and to the extent that it receives payment from the owner for the subcontractor’s work. Thus, under a “pay-if-paid” provision, there is a transfer of risk of the owner’s non-payment from the general contractor to the subcontractor.

Differing Views and Rationales on Enforcement of “Pay-if-Paid” Provisions
States all over the map are indeed “all over the map” on whether and under what circumstances general contractors can enforce “pay-if-paid” provisions that only obligate them to pay subcontractors if they are paid first. The majority view among the states is that “pay-if-paid” provisions are valid and enforceable where they are clearly and unambiguously drafted to show that a transfer of payment risk from the contractor to the subcontractor is under-
stood and intended by the parties. See, e.g., Main Elec., Ltd. v. Printz Servs. Corp., 980 P.2d 522, 528 ( Colo. 1999) (“to create a pay-if-paid clause in a construction contract, the relevant contract terms must unequivocally state that the subcontractor will be paid only if the general contractor is first paid by the owner and set forth the fact that the subcontractor bears the risk of the owner’s non-payment”); DEC Electric, Inc. v. Raphael Constr. Corp., 558 So.2d 427, 429 (Fla. 1990) (“[i]f a [risk-shifting] provision is clear and unambiguous, it is interpreted as setting a condition precedent to the general contractor’s obligation to pay. …In purported risk-shifting provisions between a contractor and subcontractor, the burden of clear expression is on the general contractor”); Wellington Power Corp. v. CAN Sur. Corp., 217 W. Va. 33, 41, 614 S.E.2d 680 (2005) (“[a] plain reading of these contracts indicates that the pay-if-paid condition precedent clause is certain, definite and unequivocal in meaning. As a result, the condition precedent provision is to be enforced by this Court and not construed”).

Where the transfer of payment risk is not clearly and unambiguously set forth, the courts in states adhering to the majority view will generally refuse to enforce the purported provision as a “pay-if-paid” provision governing the subcontractor’s right to payment, and construe it instead as a “pay-when-paid” provision governing the timing of such payment. See Main Elec., Ltd., supra, 980 P.2d at 523 (“we construe the relevant payment phrase in this contract, that the subcontractor would be paid ‘provided like payment shall have been made by owner to contractor,’ to be insufficient to constitute a condition precedent that results in shifting risk of the owner’s nonpayment from the general contractor to the subcontractor…. Thus, we hold that the payment clause in this contract is a pay-when-paid clause—that is, an unconditional promise by the general contractor to pay its subcontractor even if the owner becomes insolvent”).

In states where “pay-if-paid” provisions are deemed valid and enforceable, the general rationale behind such enforcement is based upon parties’ “freedom to contract.” In other words, where there is a clearly-evidenced intent in a construction contract to condition a general contractor’s duty to pay a subcontractor upon the general contractor’s own receipt of payment from the owner, and thereby have each party expressly assume its own risk of loss if the owner becomes insolvent or otherwise defaults, the court engaging in contract interpretation should give effect to this clearly-expressed intent of the contracting parties. See Wellington Power Corp., supra, 217 W. Va. at 37 (“[o]ur law provides that, under the broad liberty of contract allowed by law, parties may make performance of any comparatively, or apparently, trivial and unimportant covenant, agreement or duty under the contract a condition precedent, and, in such case, the contract will be enforced and dealt with as made”).

Moreover, in states where “pay-if-paid” provisions are generally upheld as valid and enforceable, not only do the general contractors benefit, but, in most cases, so do construction sureties issuing payment and performance bonds on behalf of the general contractor. Perhaps the most fundamental principal of suretyship law is that the liability of a surety under its bond is commensurate with the liability of the bond principal under the underlying bonded contract. In other words, the surety “steps into the shoes” of its bond principal, and is entitled to assert virtually any defense (except for purely personal defenses such as bankruptcy or lack of capacity to contract) against the subcontractor/bond claimant that the general contractor has against the subcontractor under their construction contract. Thus, the surety, in responding to the subcontractor’s performance bond claim, can assert the “pay-if-paid” provision as a defense to liability under the bond in the same manner that the general contractor can assert such provision as a defense to liability under the contract between it and the subcontractor. See Wellington Power Corp., supra, 217 W. Va. at 40 (“in a public construction project, a pay-if-paid condition precedent in a contract between a subcontractor and a contractor does not violate the public policy of this State found in the public bond statute, W.Va.Code §38-2-39 (2004). Thus, a pay-if-paid clause which prevents a subcontractor from proceeding against a contractor in the absence of the owner’s payment to the contractor, also prevents the subcontractor form proceeding against the contractor’s surety under a payment bond acquired by the contractor pursuant to W.Va.Code §38-2-39 (2004)”).

Interestingly, in Maryland, which is among the majority of states where “pay-if-paid” provisions can be deemed valid and enforceable, there is a statute that provides: “[a] provision 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 mechanic’s lien; or (2) sue on a contractor’s bond.” Md. Real Property Code Ann. §9-113 (2014). A likely unintended result of this statute, however, is that, by preventing a surety from asserting the “pay-if-paid” provision as a defense to a bond claim, Mary-
land may have unwittingly gone from the majority view of enforcement of “pay-if-paid” provisions to the minority view of non-enforcement, at least in cases where the general contractor is bonded. That is because a surety who is obligated to pay a bond claim notwithstanding a valid and enforceable “pay-if-paid” provision will likely have contractual indemnity rights against the general contractor/bond principal (and oftentimes the general contractor’s owners and their spouses personally as well) pursuant to a general agreement of indemnity signed by the general contractor and personal indemnitors in consideration for the surety’s issuance of its bond. Thus, although the general contractor may not be directly liable to the subcontractor because of the “pay-if-paid” provision, it (and perhaps its owners and their spouses as well) would be still indirectly liable to the subcontractor because it/they would be obligated to indemnify the surety who paid the subcontractor’s bond claim. In this sense, the “pay-if-paid” provision, although putatively valid and enforceable, affords little or no protection to the general contractor.

While courts in a majority of states will enforce “pay-if-paid” provisions that are clearly and unambiguously drafted, and plainly demonstrate the intent to transfer the owner’s risk of non-payment from the general contractor to the subcontractor, a sizable minority of states, in an effort to protect the rights of subcontractors, have outright invalidated “pay-if-paid” provisions as against the state’s public policy. These prohibitions have occurred either judicially or statutorily. See, e.g., Wm. R. Clarke Corp. v. Safeco Ins. Co., 15 Cal.4th 882, 886, 938 P.2d 372 (1997) (“We conclude that pay if paid provisions like the one at issue here are contrary to the public policy of this state and therefore unenforceable because they effect an impermissible indirect waiver or forfeiture of the subcontractors’ constitutionally protected mechanic’s lien rights in the event of non-payment by the owner. Because they are unenforceable, pay if paid provisions in construction subcontracts do not insulate either general contractors or their payment bond sureties from their contractual obligations to pay subcontractors for work performed.”); West-Fair Elec. Constr. v. Aetna Cas. & Sur. Co., 87 N.Y.2d 148, 158, 661 N.E.2d 967 (1995) (“We hold that a pay-when-paid provision which forces the subcontractor to assume the risk that the owner will fail to pay the general contractor is void and unenforceable as contrary to public policy set forth in the Lien Law §34. By contrast, a pay-when-paid provision which merely fixes a time for payment does not indefinitely suspend a subcontractor’s right to payment upon the failure of an owner to pay the general contractor, and does not violate public policy as stated in the Lien Law’); see also, e.g., N.C.Gen.Stat. §22C-2 (2013) (“Performance by a subcontractor in accordance with the provisions of its contract shall entitle it to payment from the party with whom it contracts. Payment by the owner to a contractor is not a condition precedent for payment to a subcontractor and payment by a contractor to a subcontractor is not a condition precedent for payment to any other subcontractor, and an agreement to the contrary is unenforceable”); Annotated Laws of Massachusetts GL ch. 149, §29E(e) (pay-if-paid provisions are generally void and unenforceable, except for limited circumstances involving the subcontractor’s non-performance under the contract and failure to timely cure such non-performance, or the owner’s insolvency).

In those states that refuse to enforce “pay-if-paid” provisions, a commonly expressed rational for such a view is that a “pay-if-paid” provision violates a subcontractor’s rights to payments for labor and materials furnished on a construction project to which it would otherwise be entitled and such a provision flies in the face of the subcontractor’s constitutionally or statutory protected lien rights. Moreover, such a provision permits larger, sophisticated general contractors to shift the risk of the owner’s insolvency and/or default unjustly onto smaller, less sophisticated subcontractors, who have little or no ability to gauge, control, or monitor such risk. And, because of lack of privity, the subcontractor generally has no right to pursue the owner directly for breach of contract (although it may be able to acquire privity through an assignment of the general contractor’s rights against the owner under the prime contract). Finally, even in cases where there is a performance surety bond in place, the subcontractor will still be without an effective remedy because, as discussed above, the surety will almost always (except in Maryland) be able to assert the “pay-if-paid” provision as a defense to the subcontractor’s bond claim.

The Recent Transtar Electric Case in Ohio

Even though “pay-if-paid” provisions can be upheld as valid and enforceable in a majority of the states, there nonetheless exists a lack of uniformity among such states as to whether a specific “pay-if-paid” provision is “clear and unambiguous enough” to be deemed valid and enforceable in any or all of such states. Indeed, a specific “pay-if-paid” provision may be deemed sufficiently “clear and unambiguous” to be valid and enforceable in one state, but not sufficiently “clear and unambiguous” so as to be valid and enforceable in one or more neighboring states. In fact, different courts in the same state can often disagree on this issue, as evidenced by the history of a recent “pay-if-paid” case through an intermediate appellate court, and then the supreme court in Ohio, where the author practices.

In December 2012, in Transtar Electric, Inc. v. A.E.M. Electric Services Corporation, 2012-Ohio-5986, 983 N.E.2d 399 (2012), the Court of Appeals of Ohio for the Sixth Appellate District was called upon to decide whether the following provision was a valid and enforceable “pay-if-paid” provision: RECEIPT OF PAYMENT BY CONTRACTOR FROM OWNER FOR WORK PERFORMED BY SUBCONTRACTOR IS A CONDITION PRECEDENT TO PAYMENT BY CONTRACTOR TO SUBCONTRACTOR FOR THAT WORK.

In holding that this provision was a “pay-when-paid” provision rather than a “pay-if-paid” provision, the court, relying upon a decision by the United States Court of Appeals for the Sixth Circuit in Thos. A. Dyer Co. v. Bishop Internl. Eng. Co., 303 F.2d 655 (6th Cir. 1962), stated as follows: [I]f a contract provision is to be construed as a pay-if-paid clause, the language must clearly and unambiguously indicate that the intent of the parties was to shift the risk of payment from the general contractor to the subcontractor. The sine qua non of such a provision is a clear unambiguous statement that the sub-
contractor will not be paid if the owner does not pay.

Id., 983 N.E.2d at 405. The court went on to state that the fact that the provision states that it is a condition precedent was not enough to make the provision a valid and enforceable “pay-if-paid” provision, holding:

The provision must be made plain, in

Moreover, such a provision permits larger, sophisticated general contractors to shift the risk of the owner’s insolvency and/or default unjustly onto smaller, less sophisticated subcontractors, who have little or no ability to gauge, control, or monitor such risk.

plain language, that a subcontractor must ultimately look to the owner of the project for payment. While the words “condition precedent” may be helpful, the term is not sufficiently defined to impart that both parties understand that the provision alters a fundamental custom between a general contractor and a subcontractor. Consequently, absent language making manifest the intent to shift risk of payment, the provision must be construed as a pay-when-paid clause.

In the present matter, we find no language sufficient to clearly and unambiguously indicate that the parties intended to transfer the ultimate risk of nonpayment to the subcontractor. Consequently, the clause at issue must be interpreted as a pay-when-paid provision.

Id., 983 N.E.2d at 405-06.

A little more than a year and a half later, in July 2014, the Ohio Supreme Court, in Transtar Eclectic, Inc. v. A.E.M. Electric Services Corp., 140 Ohio St. 3d 193, 16 N.E.3d 645 (2014), reversed the Sixth Appellate District Court of Appeals, holding the following in its syllabus:

1. When a contract provides that payment by a project owner to a general contractor for work performed by a subcontractor is a condition precedent to payment by the general contractor to the subcontractor, the provision is a pay-if-paid provision.

2. The use of the term “condition precedent” in the payment provision of a contract between a general contractor and a subcontractor clearly and unequivocally shows the intent of those parties to transfer the risk of the project owner’s nonpayment from the general contractor to the subcontractor.

Id., 16 N.E.3d at 646 (paras. 1 and 2 of syllabus). In interpreting the payment provision at issue, the Ohio Supreme Court followed the reasoning of a 2012 decision by the United States Court of Appeals for the Seventh Circuit, and stated:

The above language stating that receipt of payment by the contractor is a condition precedent to payment to the subcontractor requires that the owner first pay the contractor. The parties intended that the risk of the owner’s nonpayment shift to the subcontractor rather than remain with the general contractor. To echo the Seventh Circuit Court of Appeals, “This provision means just what it says—that [the contractor’s] duty to pay [the subcontractor] is expressly conditioned on its own receipt of payment—thus evincing the parties’ unambiguous intent that each party assumes its own risk of loss if [the owner] becomes insolvent or otherwise defaults.” BMD Contrs., Inc. v. Fid. & Deposit Co. of Maryland, 679 F.3d 643, 650 (7th Cir.2012). Accordingly, A.E.M. and Transtar have agreed to a pay-if-paid clause.

The supreme court flatly rejected the court of appeals’ holding that the payment provision’s use of the term “condition precedent” was insufficient to create a valid and enforceable “pay-if-paid” provision, holding:

Finally, the use of the term “condition precedent” negates the need for additional language to demonstrate the intent to transfer the risk. It is true that the rule in Dyer requires that the parties’ intent to transfer the risk of nonpayment be clear. 303 F.2d at 660-661. The use of the term “condition precedent” expresses that intent. The Seventh Circuit thoroughly discussed this reasoning in BMD Contrs.:

We do not disagree that to transfer the risk of upstream insolvency or default, the contracting parties must expressly demonstrate their intent to do so; that is the rule from Dyer. But by clearly stating that the contractor’s receipt of payment from the owner is a condition precedent to the subcontractor’s right to payment, the parties have expressly demonstrated exactly that intent. Adding specific assumption-of-risk language would reinforce that intent but is not strictly necessary to create an enforceable pay-if-paid clause. Dyer does not hold otherwise.

* * *

Although it’s possible to reinforce the clarity of a pay-if-paid clause by using redundant language—e.g., “in agreeing to this condition precedent, subcontractor assumes the risk of owner’s insolvency”—additional language like this is not necessary if the meaning of the condition precedent is otherwise clear. MidAmerica Constr. Mgmt., Inc. v. MasTec N. Am., Inc., 436 F.3d 1257, 1263 (10th Cir.2006) (noting that a similarly worded subcontract’s “failure to say all that it might have said is not enough to throw the intent of the contracting parties into doubt”). (Emphasis sic.) 679 F.3d at 650.

Id., 16 N.E.3d at 651.

Analysis

The recent Court of Appeals of Ohio for the Sixth Appellate District and the Ohio Supreme Court decisions in Transtar Electric amply demonstrate the inconsistency and non-uniformity within which courts, even those in the same jurisdiction, let alone those across jurisdictions, interpret and determine the validity and enforceability of pay-if-paid provisions in construction contracts. In the end, however, the Ohio Supreme Court seemingly got
it right—by trying to keep it simple. Too often, provisions in construction contracts, and indeed contracts in general, are cluttered with lengthy run-on-sentences and repetitive, redundant language that serve to obfuscate, rather than clarify, the intent of the parties. While the court of appeals’ decision in Transtar Electric was correct in stating that a “pay-if-paid” provision “must be made plain, in plain language, that a subcontractor must ultimately look to the owner of the project for payment,” the supreme court’s decision in Transtar Electric was likewise correct in holding that by providing that the general contractor’s receipt from payment from the owner is a “condition precedent” to the subcontractor’s right to receive payment from the owner, this plain language requirement is satisfied, and the parties’ intent to transfer risk of non-payment is sufficiently clear and unambiguous.

Indeed, by setting forth a clearly defined standard for when pay-if-paid provisions will be valid and enforceable, the Ohio Supreme Court’s decision in Transtar provides a scenario of consistency and predictability for the general contractor, its surety, and its subcontractors. Moreover, this transfer of non-payment risk through a “pay-if-paid” condition precedent does not bestow undue hardship upon a subcontractor, even one who has less sophistication, economic wherewithal and/or bargaining power vis-à-vis the general contractor. The risk-assuming subcontractor can, and should, take into account this transfer of risk in setting its subcontract price. And, in cases where the owner did not pay the general contractor because of the general contractor’s defective workmanship or other act or omission, the subcontractor should not be left holding the bag. Indeed, the so-called prevention doctrine will generally disallow an unsavory or defaulting general contractor to hide behind the non-occurrence of a condition precedent it helped cause. The prevention doctrine provides that if a promisor prevents or hinders a condition from occurring, the condition is excused. Restatement of the Law 2d, Contracts (1981) 258, Section 245. The conduct of the promisor does not even have to be the “but for” cause of the condition’s failure. It is enough that it materially contributed to it. Brothers v. Brown & Root, Inc., 207 F.3d 717, 725 (4th Cir. 2000); see also Aarrow Equipment & Services, Inc. v. Travelers Casualty and Surety Company of America, 4th Cir. No. 10-1375, 2011 LEXIS 5541 (Mar. 18, 2011) (applying material contribution standard to nonpayment condition in pay-when-paid contract).

Conclusion
As is the case in many areas of the law, the validity and enforceability of “pay-if-paid” provisions in construction contracts differs significantly across jurisdictions, and oftentimes even within the same jurisdiction. The recent decision of the Ohio Supreme Court in Transtar Electric, Inc. v. A.E.M. Electric Services Corp. has clarified, simplified, and furthered the objectives of consistency and predictability in this unsettled area of law, and, hopefully, courts in other jurisdictions have done, or will do, likewise.