FEATURE

‘Pay-If-Paid’ Clauses—The Freedom to Contract vs. the Subcontractor’s Statutory Rights to Enforce Payment by Mechanic’s Liens or by Payment Bond

by James Palecek, Palecek & Palecek, PLLC

It has been noted that a majority of states in America allow a general contractor and a subcontractor to enter into a construction contract which “shifts the risk” of non-payment from the owner to the subcontractor. See *“PAY IF PAID” CONTRACT PROVISIONS, Providing Some Enforcement Consistency and Predictability in an Unsettled Area of Law, 57 No. 2 DRI For Def. 23, February 2015, by Ronald P. Friedberg.* On the other hand, a vocal minority of states do not allow this contractual risk-shifting, and part of the reasoning in some of these states, including California, addresses the subcontractor’s statutory rights to lien property or to make a bond claim when there has been non-payment from the general contractor, regardless of the reason for the non-payment. See *FREEDOM FROM THE FREEDOM-TO-CONTRACT: CALIFORNIA SUPREME COURT INVOKES PUBLIC POLICY TO INVALIDATE “PAY IF PAID” CLAUSES IN CONSTRUCTION CONTRACTS, 21 T. Jefferson L. Rev. 253, October 1999, by Eric N. Larson. However, for the majority of states, a valid “pay if paid” clause will invalidate a subcontractor’s lien or payment bond remedy.*

This article will first address the state of the “pay if paid” law in Arizona. Then, it will compare it to California’s public policy against such clauses. Finally, this article will discuss the majority rule whereby such clauses are enforceable and address the inherent conflict in not allowing subcontractors the rights to enforce lien and bond claims when payment is not made by the owner.

Arizona Enforces Valid ‘Pay If Paid’ Clauses

The current case precedent in Arizona on a “valid” pay-if-paid clause is *L. Harvey Concrete, Inc. v. Agro Constr. Supply Co.,* 189 Ariz. 178, 939 P.2d 811 (App. 1997). In *Harvey*, the trial court concluded as a matter of law that the pay-if-paid provision in the subcontract created a condition precedent to contractors’ obligation to pay subcontractor. *Id.* Defendants argued and the court agreed that,

RESOURCES:

Contingent Payment

Under “Contracts and Project Management” in Member Resources area of ASA Web site, www.asaonline.com:

- Subcontractor’s Negotiating Tip Sheet on Pay-If-Paid Clauses
- Contingent Payment FAQ
- ASA Contingent Payment Clauses in the 50 States
- White Paper: Mastering Contingent Payment

Under *“LogIn/Access Member Resources” on ASA Web site,* www.asaonline.com:

- Video-on-Demand: The Big IF in Pay-If-Paid Clauses (Item #8057)

"Arizona law permits an absolute shifting of the risk of nonpayment through a pay-when-paid provision that clearly and unambiguously establishes an intent to create a condition precedent." *Id.* at 180. No "magic words" are required, just "contractual language demonstrating the parties' unequivocal intent that the obligation be paid out of that fund and not otherwise." *Id.* at 182. The relevant contract language in the *Harvey* case reads as follows:

Notwithstanding anything to the contrary in the preceding paragraphs of this agreement, subcontractor agrees as a condition precedent to payment, of either progress or final payment, that the owner shall have first paid the payment applied for to the contractor, and that payment for either progress payments or final payment is not due and owing to the subcontractor as provided for herein until the owner has made such payment to the contractor. The subcontractor recognizes that the source of funding for this subcontract agreement are [sic] the progress and final payments that are to be made by the owner to contractor. Id. at 180, 939 P.2d at 813 (emphasis added).

However, not all "contingent payment" language in contracts in Arizona constitute "pay IF paid" clauses. Some clauses, depending on the language, constitute merely "pay WHEN paid" clauses, which do NOT absolutely shift the risk of payment from the general contractor to the subcontractor.

In *Watson Const. Co. v. Reppel*, 123 Ariz. 138, 140, 598 P.2d 116, 118 (App. 1979), the Court of Appeals considered language in a construction subcontract that said the general contractor would pay the subcontractor "promptly upon receipt from the Owner, the amount received by the Contractor on account of the Sub-Contractor's work to the extent of the Sub-Contractor's interest therein." The subcontract in Watson also had language that said "[a]t all times subcontractor shall be paid to the extent that the contractor has been paid on his account." Id. Considering the language of the subcontract, the court in Watson held that the subcontract "created fixed obligations" to pay the subcontractor, and the payment provisions "merely provid[ed] a convenient or normal time for payment." Id.

Similarly, in *Darrell T. Stuart Contractor of Arizona, Inc. v. Bridges & Rust-Proofing, Inc.*, 2 Ariz. App. 63, 64, 406 P.2d 413, 414 (1965), the Court of Appeals addressed language in a subcontract that provided, "The contractor shall pay the subcontractor's pay estimate (less ten percent (10%) retainage within ten days after receipt of payment by the contractor and as allowed by the Government." In an opinion that reviewed the history of pay-if-paid and pay-when-paid provisions, the court in *Darrell Stuart* held:

[T]he plaintiffs' entitlement was not conditioned upon the receipt of the money by the defendant. If and when the defendant received money from the contractor, the defendant was obligated to pay the plaintiffs within 10 days from said receipt. If the defendant did not receive all of its money from the contractor, the defendant nevertheless remained indebted to the plaintiffs and the plaintiffs were entitled to payment within a reasonable period of time following the completion of the performance of their contract obligation. Id., 2 Ariz. App. at 65, 406 P.2d at 415.

Third, the court in *Pioneer Roofing Co. v. Mardian Constr. Co.*, 152 Ariz. 455, 733 P.2d 652 (App.1986) reviewed contract language that provided "the recovery by Subcontractor for [additional] work shall be conditioned upon a prior recovery therefore by Contractor from the Owner." 152 Ariz. at 469, 733 P.2d at 666. Even with language saying that payment was "conditioned" on approval by the owner, the court rejected the general contractor's defense, holding, "we find no proof of an intent that payment to [the subcontractor] was to be made exclusively or only from funds paid by or on behalf of [the owner]." Id. at 470, 733 P.2d at 667.

The emphasized language from the contract in *L. Harvey* is distinct from the three earlier cases, *Watson*, *Darrell Stuart* and *Pioneer Roofing*. The subcontract in *L. Harvey* specifically referred to a "condition precedent to payment:"

The language used here is much stronger than that used in Watson or Pioneer Roofing in showing an intent to limit recovery to the payments received from the owner. The contract between Agate and Harvey expressly states that receipt of payment from the owner is a "condition precedent" to recovery. It further states that "payment for either progress payments or final payment is not due and owing ... until the owner has made such payment to the contractor." Finally, the contract identifies as the source of funding for the subcontract the "progress and final payments that are to be made by the owner to the contractor." We find the language here sufficiently reflects the concept of exclusivity necessary to demonstrate that the parties clearly and unequivocally intended to create a condition precedent shifting the risk of nonpayment from Agate to Harvey. Thus, the condition precedent is valid and enforceable. L. Harvey Concrete, Inc. v. Agro Const. & Supply Co., 189 Ariz. at 182, 939 P.2d at 815 (emphasis original).

California's Supreme Court Invalidated "Pay If Paid" Clauses in 1997

In 1997, the same year that L. Harvey was decided in Arizona, the California Supreme Court affirmed (4-3) the Second District's decision upholding the right of subcontractors to collect from a general contractor's surety when there is a valid "pay if paid" provision and when, upon the owner's default, the general contractor refuses payment to the subcontractor. Wm. R. Clarke Corporation v. SAFECO Insurance Company of America, 15 Cal. 4th 882, 886, 938 P.2d 372, 374, 64 Cal. Rptr. 2d 578, 580 (1997).

The California Supreme Court went much further though by invalidating

all "pay if paid" clauses because, in short, they amount to a waiver of subcontractors' constitutionally protected rights to mechanic's liens, which rights are found throughout the California laws, including, among other provisions, the right to lien property where one has provided labor or materials (*Cal Const. of 1879, art. XIV, Sec. 3 (1976*), the preclusion of the waiver of such liens in contractual provisions where the terms "waive, affect, or impair the claims and liens…shall be null and void" (*Cal Civil Code Sec. 3262*). Moreover, the *Cal Civil Code Section 3096* defined the parameters for which bonds could be issued, allowing a contractor to "foreclose the liens provided for in this title, and, finally, Section 3226 mandated that sureties would be "released from liability…by reason of any breach of contract between the owner and the original contractor." See "*Freedom from the freedom to contract…, Larson, at 276-277.*

In this law review article, the author, Eric Larson, does an in-depth analysis of the case and the many issues that were addressed. Importantly, he provides a critique on the Supreme Court's decision and finds that the court got it right. He addresses the various arguments made by general contractors in favor of pay if paid clauses, including freedom to contract. *Id at 272-281.*

He also alludes to courts in other states that have found "ambiguity" in these contractual payment provisions (Florida, as an example) so as to not invalidate the subcontractors' rights to mechanic's liens, while a Virginia court took great pains in its analysis before it was fully satisfied that the subcontractor "truly intended" to share the risk of owner default.

Larson concludes that California's Supreme Court got it right because invalidating "pay if paid" clauses will bring predictability to the ambiguous area of contract interpretation: "Building contractors will be able to focus on their business of constructing projects, as opposed to the wrangling over contractual vernacular and the legal nuances that emanate there from. Subcontractors may now take solace with the assurance that their mechanic's liens will protect them as designed, and that sophisticated contract drafters will not be able to undermine the important constitutional protection."

The Alternative (and Majority) View: Ohio's Transtar Electric Case

In contrast, the majority of states allow the enforcement of pay if paid provisions. Ronald Friedberg analyzed the "state" of this contingent payment clause in a variety of states and found that there is still a lack of "settlement" in the states. "*PAY IF PAID" CONTRACT PROVISIONS, Providing Some Enforcement Consistency and Predictability in an Unsettled Area of Law, 57 No. 2 DRI For Def. 23, February 2015, by Ronald P. Friedberg.*

In *Transtar Electric, Inc. v. A.E.M. Electric Services Corp., 140 Ohio St. 3d 193, 16 N.E. 3D 645 (2014)*, the Ohio Supreme Court reversed the Sixth Appellate District Court of Appeals saying, essentially, that the words "condition precedent" in the pay if paid clause ARE clear and unambiguous (by themselves) to clarify to a subcontractor that it is giving up its rights to enforce payment if the Owner does not pay the general contractor (including the giving up of its mechanic's lien rights).

Friedberg finds this decision to be right and to create some certainty in Ohio law. He further believes that the "transfer of non-payment risk through a "pay if paid" condition precedent does not bestow undue hardship upon a subcontractor, een one who has less sophistication, economic wherewithal and/or bargaining power vis a vis the general contractor" because "the risk-assuming subcontractor can, and should, take into account this transfer of risk in setting the subcontract price…" He further says that the "prevention" doctrine will prevent an unsavory general contractor from enforcing the clause.

However, while noting that in the robust minority of states (California, New York, North Carolina, and Massachusetts, as examples), the courts have addressed the constitutionally or statutorily-protected rights of subcontractors to enforce mechanic's liens, nowhere in his conclusions does it appear that Friedberg addresses this same public policy protection in his state of Ohio.

There are those states that clearly see that a contractual pay if paid provision cannot undermine a subcontractor's lien and bond rights protected by the laws of a state; however, contractual waiver of lien and bond rights is found in a majority of states, which is dubious. Clearly, no subcontractor ever intends to "waive" its mechanic's lien or bond rights. However, until such time that the issue reaches the highest court of these states, general contractors will continue including and asserting these provisions to keep subcontractors from enforcing their payment rights.

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