

## **Contingent Payment Clauses – Does Your Contract Forfeit or Delay Payment?**

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**by David E. Merrell, Esq.**

Contractors should take note and subcontractors should beware of the inherent risks in executing a contract with a “pay-if-paid” or “pay-when-paid” clause. Such clauses respectively forfeit and delay payment to the subcontractor when the owner fails to pay the contractor. Pay-if-paid clauses affect entitlement to payment by shifting the risk of owner non-payment to the subcontractor. Pay-when-paid clauses merely affect the timing of payments and keep the risk of owner non-payment on the contractor. In addition to being used to forfeit or delay progress and final payments, pay-if-paid and pay-when-paid clauses may forfeit or delay payment for changes, delay damages, claims, etc.<sup>i</sup>

### **Pay-if-Paid Clauses**

A pay-if-paid clause is one that makes downstream payment from the contractor to the subcontractor contingent upon upstream payment from the owner to the contractor. In other words, even if the subcontractor fully performs its work, the contractor has no obligation to pay the subcontractor if it did not receive payment from the owner. Pay-if-paid clauses, therefore, spread the risk of owner non-payment to the subcontractor. This is a significant risk for subcontractors that typically have no relationship with owners. Yet on the other hand, it is significant for contractors on large projects to solely bare the risk of owner insolvency.<sup>ii</sup> An example of a pay-if-paid clause in a standard industry contract is as follows:

**AGC Document No. 655 Standard Form of Agreement Between Contractor and Subcontractor (Where the Contractor and Subcontractor Share the Risk of Payment)**

8.2.5 TIME OF PAYMENT Receipt of payment by the Contractor from the Owner for the Subcontract Work is a condition precedent to payment by the Contractor to the Subcontractor. The Subcontractor hereby acknowledges that it relies on the credit of the Owner, not the Contractor for payment of Subcontract Work. Progress payments received from the Owner for the Subcontractor for satisfactory performance of the Subcontract Work shall be made no later than seven (7) days after receipt by the Contractor of payment from the Owner for the Subcontract Work.

### **Pay-when-Paid Clauses**

A pay-when-paid clause is one that does not contain specific language, as in the example above, which unequivocally shifts the risk of owner-non-payment to the subcontractor. Without such specific language, courts are hesitant to impose a forfeiture of payment on subcontractors, and instead require payment within a reasonable time. For example, the following language, which appears to create a payment contingency, would probably be interpreted as a pay-when-paid clause because it does not unequivocally state that contractor payment is a condition precedent to subcontractor payment:<sup>iii</sup> “The Contractor shall pay the Subcontractor each progress payment within three working days after the Contractor receives

payment from the Owner.”<sup>iv</sup> Such clauses are typically interpreted to merely affect the timing of payment and not entitlement to payment. Other examples of pay-when-paid clauses in standard industry contracts are as follows:

**AIA Document A201 – 1997, General Condition of the Contract for Construction**

§ 9.6.2 The Contractor shall promptly pay each Subcontractor, upon receipt of payment from the Owner, out of the amount paid to the Contractor on account of such Subcontractor's portion of the Work, the amount to which said Subcontractor is entitled, reflecting percentages actually retained from payments to the Contractor on account of such Subcontractor's portion of the Work. The Contractor shall, by appropriate agreement with each Subcontractor, require each Subcontractor to make payments to Sub-subcontractors in a similar manner.

**AGC Document No. 650, Standard Form of Agreement Between Contractor and Subcontractor (Where the Contractor Assumes the Risk of Owner Payment)**

8.2.5 TIME OF PAYMENT Progress payments to the Subcontractor for satisfactory performance of the Subcontract Work shall be made no later than seven (7) days after receipt by the Contractor of payment from the Owner for the Subcontract Work. If payment from the Owner for such Subcontract Work is not received by the Contractor, through no fault of the Subcontractor, the Contractor will make payment to the Subcontractor within a reasonable time for the Subcontract Work satisfactorily performed.

### **Risk Management**

Because “the law abhors a forfeiture,” many states have either barred pay-if-paid clauses, by statute or refused to enforce them in court. This policy ensures payment to laborers and subcontractors. Of the states that do enforce them, most do not interpret them so as to also create a forfeiture of mechanic’s lien or surety bond rights. While it is uncertain whether or not Utah courts will enforce pay-if-paid clauses, Utah Code Section 13-8-4(3)(a) expressly bars an owner, on a commercial project, from defending against a mechanics’ lien by relying upon a contingent payment clause in its contract. Many other aspects of this area of the law are still uncertain in Utah and Idaho.

Regardless of the law, with competent legal advice, language can be negotiated to lessen the risk of pay-if-paid or pay-when-paid clauses. For example, pay-if-paid clauses may be diffused by clearly stating that despite the owner’s failure to pay, the contractor retains the duty to ultimately pay the subcontractor. Furthermore, pay-when-paid clauses may be diffused by inserting a schedule of payment dates or clearly stating when payments are due.<sup>v</sup> Other alternative language might limit the standard pay-if-paid clause as follows:<sup>vi</sup>

- Limit enforcement of the pay-if-paid clause to those subcontractors whose fault caused the owner to withhold payment to the contractor.
- Limit the duration of the pay-if-paid clause to a specific period of time.
- Limit the scope of the pay-if-paid clause to not forfeit mechanic’s lien and bond rights.

Therefore, before you sign your next contract, ask yourself the following questions: “Does this contract have a pay-if-paid or pay-when-paid clause?” “If so,

how can I protect myself from forfeiture or delay of payment upon insolvency of the owner?”

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#### Endnotes.

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<sup>i</sup> Daniel S. Brennan et al. eds., The Construction Contract Book: How to Find Common Ground in Negotiating Design and Construction Contract Clauses 150 (Jennifer A. Nielsen contributing ed. 2004).

<sup>ii</sup> *Id.*

<sup>iii</sup> *Id.* at 149-150.

<sup>iv</sup> AIA Document A401 – 1997 Standard Form of Agreement Between Contractor and Subcontractor.

<sup>v</sup> Michael Dodd and J. Duncan Findlay eds., State-By-State Guide to Construction Contracts and Claims 632 (Robert A. Anderson, *Esq.* contributing author 2006).

<sup>vi</sup> Brennan at 152.