# Understanding the distinction and consequences of contingent payment clauses

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Perhaps no doctrine in construction law causes as much confusion as pay-if-paid and pay-when-paid provisions. In many states, the terms are used interchangeably; however, in Ohio, they mean very different things despite the seemingly identical terms. It is critically important that contractors, subcontractors, and suppliers understand the distinction and the consequences of those contingent payment clauses.

### Pay-if-paid

Pay-if-paid is the true contingent payment clause under which, for example, a contractor has no obligation whatsoever to pay its subcontractor unless and until the contractor receives payment from the owner for that subcontractor's work. If a pay-if-paid provision is included in the contract, the subcontractor is expressly agreeing that it is relying on the creditworthiness of the owner to get paid—not the contractor's creditworthiness. If the owner does not have the funds to pay, the subcontractor will not get paid. The same holds true downstream: if a subcontractor inserts a pay-if-paid provision in a contract with a sub-subcontractor—the subcontractor has no obligation to pay its sub-subcontractor unless and until the subcontractor receives payment from the contractor for the sub-subcontractor's work.

In order to qualify as a pay-if-paid provision, the contract language must explicitly indicate that the parties intended that payment from the owner to the general contractor shall be a *condition precedent* to the general contractor's obligation to pay the subcontractor. In *Transtar Electric, Inc. v. A.E.M. Electric Servs. Corp.*, 140 Ohio St.3d 193, the Ohio Supreme Court held that "the use of the term 'condition precedent' negates the need for additional language to demonstrate the intent to transfer the risk." Thus, the easiest way to create a pay-if-paid provision (or determine if what you have in your contract is a pay-if-paid provision) is to look for the words "condition precedent"—*e.g.*, "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." The use of those words is sufficient to create a pay-if-paid provision.

Such provisions are enforceable, and if the owner never pays the general contractor through no fault of the general contractor, the general contractor will never have any obligation to pay the subcontractor. The general contractor's surety will also have a valid defense to any bond claim based upon the existence of the pay-if-paid provision.

#### Pay-when-paid

Pay-when-paid typically results when someone attempts to create a pay-if-paid provision but fails to properly do so. For example, a provision that reads "[p]artial payments of the subcontract sum shall be made within ten (10) days after payment is received by the contractor from the owner" is a pay-when-paid provision. Even though the provision indicates payment will not be made from the contractor to the subcontractor until after payment is received from the owner, the provision lacks the "magic language" of *condition precedent* and is therefore <u>not</u> a pay-if-paid provision. Under such a provision, the general contractor must pay the subcontractor within a "reasonable time" even if the owner never pays the general contractor. What constitutes a "reasonable time" will be determined based upon all of the other contract provisions and surrounding circumstances.

Not all payment provisions are pay-if-paid or pay-when-paid. For example, the parties can simply agree that payment will occur within a specific time period after the pay application is submitted (*e.g.*, "contractor shall pay subcontractor within 30 days after receipt of an approved pay application"), and such provisions are enforceable.


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