Although contractors and sureties share the same goal of ensuring proper and timely completion of a project, a surety’s concerns are often invisible to the contractor. Because sureties and contractors review a contract for risk allocation much differently, both parties must make an effort to understand all contract provisions, as well as how they affect each other.

This white paper serves to briefly outline and differentiate two payment clauses, which confront subcontractors and are often utilized by general contractors, known as “Pay-If-Paid” and “Pay-When-Paid” clauses, and discuss the sureties’ take on the associated risks.

**Clauses Defined**

While the general design of both clauses acts to shift the burden of nonpayment to subcontractors by not requiring the general contractor to pay the subcontractor, unless and until the project owner has paid the general contractor, the application and enforceability of each has been shaped separately.

**Pay-If-Paid:**

Establishes the payment by the owner to the general contractor as a condition precedent to the general contractor’s obligation to pay the subcontractor.

**Pay-When-Paid:**

Suspends the general contractor’s obligation to pay the subcontractor for a reasonable time while the general contractor attempts to collect payment from the owner.
Under a “Pay-If-Paid” clause, the general contractor is required to pay the subcontractor only if the owner pays the general contractor. The condition precedent to the general contractor’s obligation to pay the subcontractor is the owner's payment. If the owner does not pay the general contractor, no obligation exists to pay the subcontractor—who bears the risk of the owner’s nonpayment. The use of the word “if” in the payment provision must be undeniably clear and unambiguous evidence of the parties’ intention to condition payment to the subcontractor upon receipt of payment from the owner. This often takes the form of “absolute conditional precedent” wording.

Under a “Pay-When-Paid” clause, there is no condition precedent to the general contractor’s obligation to pay the subcontractor. The “Pay-When-Paid” language is an absolute agreement of the general contractor to pay the subcontractor within a period of time after the general contractor is paid by the owner. The general contractor bears the risk if the owner does not pay. The general contractor has made an unconditional promise to pay, with the time of payment postponed until the happening of a certain event, or for a reasonable period of time if the owner’s payment does not happen. Such provisions do not absolutely bar payment, but merely delay the payment by the general contractor to the subcontractor for only a reasonable period of time to allow the general contractor to attempt to collect payment from the project owner. This interpretation was created through court decisions, as the original intent of the “Pay-When-Paid” provision was similar to “Pay-If-Paid.”

Noticeably absent from “Pay-When-Paid” provisions is any language indicating that payment to the general contractor is a “condition precedent” to payment to the subcontractor. While this type of language can be very detrimental to a subcontractor, clauses that include it are nevertheless legally enforceable.

**Enforceability**

There are critical distinctions between “Pay-When-Paid” and “Pay-If-Paid” clauses. As a general rule, the courts have been reluctant to enforce “Pay-If-Paid” provisions and will, when possible, interpret them as “Pay-When-Paid” provisions. However, in the absence of a statute or of case law providing that “Pay-If-Paid” provisions are against public policy or otherwise illegal, they are likely enforceable. This is especially true when the clause contains the “absolute condition precedent” language. When payment to the general contractor, by the owner, is an absolute condition precedent to payment to the subcontractor, and these terms are unambiguous in the subcontract, the subcontractor assumes the risks of delay, if not forfeiture, of compensation for work performed. If the clause does not create a clear condition precedent to the general contractor’s duty to pay, the provision will most likely be construed as a timing mechanism for payment.
The enforceability of these clauses is different from state to state and is continually transformed by emerging case law. The only way to protect your company, whether you are a general contractor or subcontractor, is to consult an attorney about how these provisions are treated in the jurisdiction you will be working in.

Risk to Surety

The associated risk to the surety depends on what role its client is holding. For a surety supporting a subcontractor, the risk is in line with its client—potential delay, if not forfeiture, of payment owed. For subcontractors especially, this can cause cash-flow issues for the company and can put other bonded projects at risk. For many subcontractors, the legal costs of contesting one of these payment clauses is beyond their means, and the surety may be asked to step in and assist.

For a surety supporting a general contractor in this situation, the risks are associated with increased project liens and payment-bond claims. As most states require that liens be filed within a certain period after completion of your portion of work or the project is complete, a subcontractor waiting for payment under a “Pay-When-Paid” or “Pay-If-Paid” clause is presented with a bit of a catch-22. They need to file a lien to preserve their lien rights, but filing a lien may complicate the payment problems for the general contractor they are waiting to collect from (and thus their payment problem) and may cause animosity when negotiations are otherwise calm.

Another option for a subcontractor waiting for payment, in addition to filing a lien, is to file a claim against the general contractor’s payment bond. This option seems to make the conditional payment clause worthless. According to a number of recent court cases, a surety is not able to enforce a conditional payment clause when responding to a payment bond claim. The surety is obligated to pay, but since its client, the general contractor, is still awaiting payment from the owner, recovering the amounts paid on the claim(s) may put stress on the general contractor’s liquidity. This can create cash-flow problems on other bonded projects as well.

Managing This Risk for a Subcontractor

For a subcontractor, mitigating this risk is simple. When reviewing or negotiating future subcontracts, look for these payment clauses and understand what the risks are. Are you being asked to assume the risk of owner insolvency or inability to pay? If so, investigating the owner’s financial position and reviewing the financing in place is important. Ultimately, the choice to take on a contract with one of these payment provisions is a business decision based on the project, the comfort level with the general contractor/owner, and your company’s ability to absorb a potential payment delay or shortfall. If you decide to go ahead, be sure to have a set course of action should the worst occur, and always retain your lien rights.

“There are certain things that a general contractor . . . can do to strengthen the conditional payment clauses . . .”
Managing This Risk for a General Contractor

There are certain things that a general contractor, who has chosen to include a “Pay-If-Paid” or “Pay-When-Paid” clause in the subcontracts, can do to strengthen the conditional payment clauses and avoid the unpleasant results should an issue arise:

- Incorporate the conditional payment language in the payment bond. Several courts have strongly suggested that had the conditional payment language been included in the payment bond, rather than merely in the subcontract, the surety would have been permitted to delay payment until the general contractor had been paid by the owner.

- Take advantage of state laws/issue state-specific bonds. Some states permit sureties to enforce conditional payment clauses if certain criteria are met. Make sure that your surety is taking full advantage of all state laws and not just issuing the same standard payment bond regardless of where the project is located.

- Name the surety in the conditional payment clause. General contractors should expressly refer to the surety in the conditional payment clause itself. Specifically, the clause should provide that payment by the general contractor or the surety is conditioned upon payment by the owner. This puts the subcontractor on notice that the clause applies not just to payment by the general contractor but also to any other payment under the bond.

- Include a Miller Act/Little Miller Act waiver in the conditional payment clause. Depending on the type of payment bond at issue, the general contractor should include an express Miller Act or Little Miller Act waiver as part of the conditional payment clause. Previous court cases strongly suggested that they would have allowed the surety to enforce a conditional payment clause if the general contractor had included a Miller Act waiver in its subcontract; but draft your waiver carefully. Miller Act waivers are generally not valid unless they mention the Miller Act by name.

The dangerous trend of recent court cases is to prohibit payment bond sureties from enforcing standard conditional payment clauses. General contractors should be aware of the significant liability problem these situations may pose, and take steps to strengthen your subcontracts and payment bonds before being caught on the wrong end of an unenforceable conditional payment clause.