

Pay When Paid Clauses - Sword & Shield

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"Pay When Paid" clauses in construction contracts are used as both a sword and a shield. If a general contractor fails to pay a subcontractor after it gets paid, the general contractor can be liable for interest and attorneys' fees to the subcontractor. This "sword" is used to force prompt payment. As illustrated in the case summary below - the clause is also a powerful "shield" for the contractor who does not get paid by the owner and faces multiple lawsuits from subcontractors.

On February 19, 2010, the U.S. Court of Appeals for the Fourth Circuit upheld the federal district court's decision dismissing a subcontractor's lawsuit against the general contractor based on a pay when paid clause.^[1] Because the owner could "no longer finance" the project, no payments were made to the general contractor. In turn, the general contractor refused to pay the subcontractor because the subcontract had a clear and unambiguous provision that said in part:

The obligation to make a payment is subject to the express condition precedent of payment therefore by the owner.

The subcontractor argued that because the subcontract incorporated the contract between the owner and the general contractor the "pay when paid" clause in the subcontract became ambiguous or subject to more than one interpretation. Pursuant to Virginia law, an ambiguity would make the pay when paid clause invalid. The alleged ambiguity was the only issue raised by the appeal.

The contract between the owner and the general contractor was a standard AIA contract. One provision therein said the general contractor would be reimbursed for "payments made" to the subcontractors. Pursuant to this provision, the subcontractor made the argument that the AIA contract contemplated the general contractor paying the subcontractor before invoicing the owner, thereby making the pay when paid clause in the subcontract ambiguous.

The Court of Appeals held the clause in the AIA contract actually dealt with the amount of reimbursement not when payment was to occur. Further, other provisions of the AIA standard contract contemplated the general contractor would pay the subcontractor after it was paid by the owner. Finally, the Court of Appeals found there was no conflict internally in the AIA contract because all provisions can be read together without conflict, all pointing towards an unambiguous "pay when paid" provision. In the Court's opinion when the AIA and subcontract were incorporated together, no ambiguity existed, and the pay when paid clause was a valid legal defense.

Courts in two other jurisdictions, Florida and Missouri, had found "almost-identical" subcontracts and AIA contracts between owners and general contractors were ambiguous enough to prevent the enforcement of the pay when paid clause. However, relying on its belief that the Virginia Supreme Court would not follow either the Florida or Missouri decisions the Court of Appeals refused to find any ambiguity.

The Court of Appeals gave great deference to a Virginia State trial court decision that found, on the SAME

project, that a subcontractor who was not paid by the same general contractor was not entitled to payment until the general was paid because the pay when paid clauses were not ambiguous. Following Virginia law, the state court refused to find the general contractor liable to its subcontractor until it was paid by the owner.

In a further attempt to both support its decision and distinguish the Florida and Missouri cases, which admittedly had similar pay when paid clauses, the Court of Appeals noted the Florida Supreme Court based its decision on an alleged desire by the Florida legislature to protect subcontractors over general contractors. Moreover, the Missouri case - merely adopted the Florida court's reasoning - without a similar finding of legislative intent in Missouri. Furthermore, Virginia law has a strong preference for "freedom to contract" which conflicts with protecting one competing party over the other.

Perhaps the final nail in the coffin of the subcontractor was the fact that after the Florida case was decided, the Florida legislature undermined the Florida Supreme Court's decision by legislatively making it easier for general contractors to enforce a pay when paid clause on jobs with payment bonds. Given the "preference" underlying the case had been undermined by subsequent legislation, the Court of Appeals refused to impute the legal reasoning of the Florida Supreme Court to a Virginia case - especially when the policies and case law in Virginia appear directly contrary to Florida.

What does all this mean? In sum, pay when paid clauses are a strong shield and a valid defense for a general contractor who has not been paid by the owner when the provision is unambiguous. The key for all concerned is to know and understand the provisions in the contract you sign AND the contract you incorporate by reference. In this case the shield prevented liability for the general contractor - at least until it gets paid.

(1) *Universal Concrete Products Corporate v. Turner Construction Co.*, (slip op. 2/19/10, Case No. 09-1569, 4th Cir.) _F.3d_, 2010 WL 572875, 2010 U.S. App. LEXIS 3279.