DUKE LAW, P.C.

PAY WHEN PAID CLAUSES: BE SURE YOU GET WHAT YOU BARGAINED FOR

"Pay When Paid" contract clauses have become a fairly common tool used by general contractors to limit financial liability to subcontractors in the event of an owner's insolvency. In a nutshell, they provide that a GC's obligation to pay the downstream party is contingent on the GC being paid by the owner. If the GC isn't paid by the owner, the GC has no obligation to pay its subcontractor. Though the wording will vary from contract to contract, Pay When Paid clauses generally look something like this:

> **Notwithstanding anything to the contrary herein, payment by the Owner to the General Contractor is a condition precedent to the Subcontractor's right to payment from the General Contractor.**
>
> **Partial payments for or on account of Work performed will be made by Contractor to Subcontractor as the Work progresses, provided however, that as a condition precedent to any such payment, like payment has been made by Owner to Contractor.**

These clauses are pretty heavy handed since they are an attempt to shift the risk for nonpayment from the GC (who contracted directly with the owner) to a subcontractor (who might have little or no relationship with the owner). As such, the question is this: Are Pay When Paid clauses actually enforceable?

In Texas, Pay When Paid clauses are typically enforceable IF they create a *condition precedent* and not simply a covenant to pay. A condition precedent is an act or event, which occurs after the making of the contract, that must occur before there is a right to immediate performance and before there is a breach of contract. They basically create a contingency, where a party has no obligation to perform X until condition Y occurs first.

While there are no magic words that are necessary to create a condition precedent, terms such as "if," "provided that," "on the condition that," or some other phrase that conditions performance usually indicate an intent to create a condition precedent. *Gulf Const. Co. v. Self*, 676 S.W.2d 624, 627 (Tex.App.–Corpus Christi 1984).

It is important that the contract language is very clear on this. Because Pay When Paid clauses tend to be fairly harsh, courts do not favor finding them in contracts. For example, in a hospital construction project, a contract between the GC and a subcontractor included the following provision:

> When the owner or his representative advances or pays the general contractor, the general contractor shall be liable for and obligated to pay the sub-contractor up to the amount or percentage recognized and approved for payment by the owner's representative less the retainage required under the terms of the prime contract. Under no circumstances shall the general contractor be obligated or required to advance or make payments to the sub-contractor until the funds have been advanced or paid by the owner or his representative to the general contractor.

The court of appeals ruled that this clause only created a covenant regarding the terms and manner of payment, not a condition precedent to payment. *Id*. As such, the general contractor did not limit its financial liability. It was required to pay its subcontractors even though the owner failed to pay the GC.

Pay When Paid clauses are an effective way for general contractors to manage risk and limit financial liability when there is a question about an owner's solvency. Like so many other terms, they are deal points to be negotiated. Parties do not want to lose the protection they worked hard to acquire because of a poorly worded contract. The key to having an effective, enforceable Pay When Paid clause is to make sure it actually creates a condition precedent. Without that, the GC has probably done nothing but re-enforce *its* obligation to pay.

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