



The Critical Path

The Newsletter of the Construction Law Committee

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When Can You Get Paid? An Evaluation of Payment Clauses in Ohio

by Andrew L. Smith



A very important, if not the most important, part of any construction contract is when the parties can get paid. Two eerily similar, yet distinct, contractual terms impact this very question, namely, “pay-when-paid” and “pay-if-paid” clauses. While both of these terms affect a contractor’s obligations to pay subcontractors when the contractor is not paid by the project owner, their practical effects differ in significant ways.

As illustrated below, contractors and subcontractors need to understand the full meaning and effect of the clauses contained in their construction contracts, and the implications those clauses have on when and if the construction project workers and companies can get paid for their work. A simple twist of a provision from “when” to “if” can make all the difference in determining whether a contractor has a duty to pay a subcontractor for work completed under a construction contract.

What Does Pay-When-Paid Mean?

The traditional payment provision in AIA Document A401 states “the contractor shall pay the subcontractor each progress payment no later than seven working days after the contractor receives payment from the owner.” In its literal sense, this clause means that if the contractor never gets paid by the owner, then the contractor is never required to pay the subcontractor.

A literal interpretation would have devastating and harsh consequences for a subcontractor. Recognizing this, courts have held such a clause is intended to cover the timing of payment in the normal course, but if the contractor does not receive payment from the owner in the normal course, or within a reasonable time thereafter, the contractor remains obligated to pay the subcontractor the amount otherwise due. Indeed, this form of payment clause only affects the timing of payment to the subcontractor and is known as a “pay-when-paid” clause.

Pay-when-paid clauses embrace the view that the general contractor bears the risk of non-payment by the project owner, and is ultimately responsible for paying the subcontractor.

A typical pay-when-paid clause reads as follows:

Payment will be made monthly as the Work progresses for the value of the completed Work as determined by the Contractor, Owner, and Architect. Invoices from the Subcontractor for progress billings must be in our hands by the 23rd day of the month and will be paid. The Subcontractor will be paid upon receipt of funds from the Owner.

What Does Pay-If-Paid Mean?

On the other hand, as you may expect, general contractors have sought to craft different, more concise, contractual language to express the intention that if the contractor is never paid by the project owner, then the contractor should never have to pay the subcontractor. Such a clause shifts the risk from the contractor “downhill” to the subcontractor. Thus, the “pay-if-paid” clause was born, which expressly makes receipt of payment from the owner a condition precedent to the contractor’s duty to pay the subcontractor.

A typical pay-if-paid clause reads as follows:



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*Payment will be made monthly as the Work progresses for the value of the completed Work as determined by the Contractor, Owner, and Architect. Invoices from the Subcontractor for progress billings must be in our hands by the 23rd day of the month and will be paid. **Payments from the Owner to Contractor are a condition precedent to Contractor's payment to Subcontractor.***

The pay-if-paid clause has not been adopted by the AIA, and states throughout the country have reached mixed opinions as to whether these clauses should be enforceable due to the competing interests of freedom of contract and overall fairness.

Last year, the Ohio Supreme Court analyzed pay-if-paid clauses for the very first time in *Transtar Elec. v. A.E.M. Elec. Servs. Corp.*, 140 Ohio St. 3d 193, 2014-Ohio-3095, 16 N.E.3d 645. In that case, the general contractor was not required to pay a subcontractor for three invoices because the project owner did not pay the general contractor, the parties' contract provided that payment by the owner to the general contractor for work performed by the subcontractor was a condition precedent to payment by the general contractor to the subcontractor. *Transtar* interpreted the following contract provision:

(b) The Subcontractor shall submit weekly certified payroll reports, and shall pay all workmen employed on the Project labor rates equal to or greater than those required by the Prime Contract. The weekly certified payroll reports shall set forth with particularity the number of hours that each employee of the Subcontractor has worked on the project.

*(c) The Contractor shall pay to the Subcontractor the amount due under subparagraph (a) above only upon the satisfaction of all four of the following conditions: * * * (iv) the Contractor has received payment from the Owner for the Work performed by the Subcontractor. **RECEIPT OF PAYMENT BY CONTRACTOR FROM THE OWNER FOR WORK PERFORMED BY SUBCONTRACTOR IS A CONDITION PRECEDENT TO PAYMENT BY CONTRACTOR TO SUBCONTRACTOR FOR THAT WORK.***

The Ohio Supreme Court held that based on the concept of freedom of contract, pay if paid clauses, if sufficiently clear, can be enforceable. The additional issue before the court was whether the term "condition precedent" was sufficient, or whether the contractor was required to further state that the risk of owner nonpayment was shifted to the subcontractor. The court held that owner payment being a "condition precedent" of payment to the subcontractor sufficiently expressed the parties' intentions.

Ohio courts require explicit language for a pay-if-paid clause to be enforceable. The crucial issue for determining if a provision is a pay-if-paid clause is whether the contract language is to be construed as a conditional promise to pay, enforceable only when and if the condition precedent has taken place. The best way to do this is to craft contractual language that actually includes the term "condition precedent," as in the *Transtar* case.

If the court determines the attempted pay-if-paid clause is unenforceable, payment to a subcontractor must occur either: (1) when a general contractor gets paid; or (2) after a reasonable period of time. *Thos. J. Dyer Co. v. Bishop Internatl. Eng. Co.*, 303 F.2d 655 (6th Cir. 1962).

Do Not Forget Mechanic's Lien Rights

Direct collection under a construction agreement is not the only avenue for a subcontractor to get paid. A subcontractor may also avail itself to mechanic's lien rights. This begs the question, can a subcontractor faced with a pay-if-paid clause file a lien claim to get paid? This is a question that has yet to be answered by most states. Generally speaking, lien laws require filings and bond terms for claims involving "an amount due." Under the terms of a pay-if-paid clause any payment to the subcontractor is arguably not "due" until the contractor is paid by the project owner. Thus, it is unclear whether a subcontractor can use lien laws to its advantage to avoid the terms of a pay-if-paid clause.

Several states, including Ohio, Indiana, and Illinois, have attempted to answer this question by statute. In Ohio, as part of the general public policy construction contract statute, the presence of a pay-if-paid clause by itself does not prejudice lien rights. Pursuant to R.C. 4113.62(E):

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*No construction contract, agreement, or understanding that makes payment from a contractor to a subcontractor or materials supplier, or from a subcontractor to a materials supplier, lower tier subcontractor, or lower tier materials supplier contingent or conditioned upon receipt of payment from any other person shall prohibit a person from filing a claim to protect rights * * * from expiring during the pendency of receipt of payment.*

However, the Ohio statute is particularly vague, and potentially only alters the deadline to file a lien claim, rather than actually allowing a lien to be enforced for amounts that never become “due” under a pay-if-paid clause. Case law has yet to specifically address these issues. Thus, we will have to wait for the courts to interpret this new area of the law.

Points to Remember

When analyzing payment provisions of any construction contract keep in mind the following:

- When a contract provides that payment by a project owner to a general contractor for work performed by a subcontractor is a condition precedent to payment by the general contractor to the subcontractor, the provision is a pay-if-paid provision.
- The use of the term “condition precedent” in the payment provision of a contract between a general contractor and a subcontractor clearly and unequivocally shows the intent of those parties to transfer the risk of the project owner’s nonpayment from the general contractor to the subcontractor. While other contract language could be used, this is the simplest method to ensure interpretation as a pay-if-paid clause.
- On the other hand, a general contractor can make an unconditional promise to pay the subcontractor, usually within a reasonable period to allow time for the general contractor to be paid. An unconditional promise to pay is a pay-when-paid payment provision. Such a promise is not dependent on or modified by the owner’s non-payment.
- When in doubt as a subcontractor, turn to mechanic’s lien rights to seek payment for work performed.

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