Understanding 2 Types Of Construction Payment Clauses

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Construction contracts are undeniably complex exercises comprising multifaceted documents that collectively define the scope, cost, schedule and conditions of the work to be performed.

Embedded in these documents are important terms and conditions such as indemnification clauses, termination clauses and warranty provisions, which demand careful consideration.

Particularly dynamic, given diverging statutory frameworks affecting construction contracts in jurisdictions across the country, are payment terms that focus on when and how owners pay contractors, and when and how contractors flow money downstream.

In many jurisdictions, the landscape is changing with a trend toward fortifying contractor protections in the context of pay-when-paid clauses, and prohibiting the use of pay-if-paid clauses. The difference, while nuanced, can get parties into trouble if the payment provisions are not compliant with statutory requirements.

The Two Types of Clauses Explained

Pay-if-Paid

Pay-if-paid clauses focus on whether you get paid, i.e., shifting the risk of nonpayment.

For example, "Payment from the Owner to the Contractor is a condition precedent to payment from the Contractor to the Subcontractor."

Pay-if-paid clauses shift the risk from general contractors to subcontractors — the risk/reward is sometimes worth the gamble, but the subcontractor must understand that it bears the risk of nonpayment from the project owner.

These provisions are currently banned in California, Delaware, Illinois, Indiana, Kansas, Montana, Nevada, New York, North Carolina, Ohio, South Carolina, Utah and Wisconsin.

States like Hawaii, Maine, Nebraska, New Hampshire, North Dakota, South Dakota and Wyoming leave the door open for pay-if-paid enforceability.

Further, for pay-if-paid clauses to be enforceable, most states require specific language. For example, in Colorado, the contract must unequivocally state the subcontractor bears the risk of the owner's nonpayment.

Further implications include the following.

Risk Allocation

The primary risk with a pay-if-paid clause is that subcontractors may find themselves in a difficult position if the general contractor fails to secure payment from the owner. This could be particularly problematic in cases where the general contractor faces financial difficulties or disputes with the project owner.

Enforceability

The enforceability of pay-if-paid clauses varies by jurisdiction. In some jurisdictions, these clauses are enforceable and can significantly limit a subcontractor's ability to recover payments. However, other jurisdictions may impose restrictions on or outright invalidate such clauses to protect subcontractors and suppliers.

Contract Negotiation

Subcontractors often negotiate against pay-if-paid clauses or seek modifications to ensure some level of protection. They may seek provisions that guarantee payment even if the general contractor encounters issues with the project owner.

Pay-When-Paid

Pay-when-paid clauses, in contrast, focus on the timing of payment, i.e., when you are going to get paid.

A sample clause might read, "Contractor shall pay Subcontractor within 15 days after receipt of payment from the Owner."

This type of term allows a general contractor to delay paying a subcontractor until the general contractor gets paid. Typically, the general contractor cannot extend the payments indefinitely under the statutory provisions in a given state, either. Most states employ a reasonable time frame for payment from a general contractor to a subcontractor. However, "reasonable" is a subjective term that is not easily defined.

Further implications include the following.

Timing Versus Contingency

The key difference is that while a pay-when-paid clause links the timing of payment to the general contractor's receipt of funds, it does not absolve the general contractor of the responsibility to pay. The general contractor must still make payment to the subcontractor within the agreed time frame after receiving funds from the owner.

Enforceability

Pay-when-paid clauses are still enforceable in some jurisdictions, but the specific terms and timing provisions must be clear and reasonable. Courts are more likely to uphold pay-when-paid clauses as long as they are compliant with statutory requirements and do not create undue delay in payment.

Contract Negotiation

Subcontractors may find pay-when-paid clauses to be more acceptable than pay-if-paid clauses because they do not completely transfer the risk of nonpayment. Negotiations might focus on ensuring that payment terms are clear, and that any delays in payment are reasonable and justifiable.

Shifting Liability of Clauses

Taking it a step further, a pay-if-paid clause shifts all the risk for payment by the owner from the general contractor or upper-tier subcontractors to the lower-tier subcontractors by stating that the general contractor has no obligation to pay the subcontractors until the general contractor receives payment from the owner, making such receipt of payment a condition precedent.

In contrast, a pay-when-paid clause provides the general contractor or upper-tier subcontractor with a reasonable time period in which to receive payment from the owner and then remit payment to the lower-tier parties.

In certain instances, general contractors or higher-tier subcontractors could wait to pay their subcontractors until they received payment for the job from the owner — pay-if-paid — shifting the risk indefinitely to the lower-tier subcontractors, as receipt of payment from the owner or upper-tier contractor was a condition precedent to any duty to pay the lower-tier.

Changing state prompt payment laws can invalidate pay-if-paid and pay-when-paid provisions in contracts, or change the timing requirements for pay-when-paid provisions. The clear trend in state legislation is an effort to level the playing field to minimize the risk of nonpayment. Prompt payment laws vary across states, with each jurisdiction establishing its own framework to ensure timely compensation in the construction industry.

However, there has been a discernible shift in recent years as state legislatures actively revise these laws to provide stronger protections for claimants. This shift reflects a growing desire to protect the rights and interests of construction participants and may affect whether the payment provisions in your contracts are enforceable.

Required Contractual Clarity

Regardless of the type of clause used, it is essential for all parties to clearly outline payment terms in their contracts. A clear understanding of the statutory requirements in the jurisdiction where the project is located is essential. Ambiguities or poorly drafted clauses can lead to disputes and potential legal challenges.

Contracts should specify:

- The conditions under which payments will be made;
- The timeline for payments; and
- Any provisions for dispute resolution, and rights and obligations during the pendency of a dispute.

Best Practices for Construction Contracts

Parties should carefully review and negotiate payment clauses to ensure they are fair and balanced.

Keeping accurate records of all transactions, communications and payments can help resolve highly contentious disputes and provide evidence in case of legal challenges.

Clear communication between parties about payment expectations and timelines can prevent misunderstandings and facilitate contract negotiation and execution.

Moving Forward With Construction Contracts

While pay-if-paid and pay-when-paid clauses both address the timing of payments in construction contracts, they differ significantly in their impact on risk allocation and enforceability.

Pay-if-paid clauses place the risk of nonpayment on the subcontractor, which can be a significant disadvantage if the general contractor encounters issues with the project owner.

Conversely, pay-when-paid clauses provide a timeline for payment but still hold the general contractor responsible for its payment obligations. Understanding these differences and their implications, as well as the applicable legal framework in the jurisdiction where the project is located, is crucial for all parties involved in construction projects to ensure fair and timely compensation.

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