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Courts will strictly enforce "pay-if-paid" provisions against subcontractors under PA law pursuant to the Sloan decision.

In Sloan v. Liberty Mutual Insurance Company, the United States Court of Appeals for the Third Circuit recently issued a precedential decision interpreting construction contract payment provisions under Pennsylvania law; more specifically, "pay-if-paid / pay-when-paid" clauses. As discussed below, the Sloan decision has broad implications for both general contractors and subcontractors to consider when negotiating and drafting construction contracts.

A Primer on "Pay-if-Paid / Pay-when-Paid" Clauses

The widely used construction contract term "pay-if-paid" means that a subcontractor only is entitled to payment from a general contractor if an owner pays the general contractor for work on a project. The practical result of this type of provision is that the risk of an owner's non-payment is shifted from a general contractor to a subcontractor.

In contrast, a "pay-when-paid" provision does not establish payment by an owner to a general contractor as a condition precedent to a general contractor’s obligations to pay its subcontractor. Rather, it is reasonably well-established that a "pay-when-paid" provision merely creates a timing mechanism for a general contractor's payment to a subcontractor. The practical result of this provision is that a general contractor must pay a subcontractor after it has been paid by an owner. If the payment from the owner to the general contractor is not made timely, or at all, the subcontractor can argue after a reasonable period of time that the general contractor must nevertheless make payment to the subcontractor for the work.

Pennsylvania courts have routinely found that if any doubt exists as to whether a construction contract payment provision is a "pay-if-paid" or "pay-when paid," the provision will be interpreted as a "pay-when-paid" clause. In the case of Sloan, the Third Circuit enforced a "pay-if-paid" clause as a risk-shifting provision in the construction contract at issue.

A Brief Explanation of the Sloan Decision

In Sloan, the owner of a construction project owned and developed condominiums in Philadelphia (the “Owner”). The Owner entered into a prime contract with the general contractor (the “GC”). The GC, in turn, entered into a subcontract with a sub-
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contractor to perform drywall and carpentry work on the project (the "Subcontractor"). The Surety issued a payment bond to the GC.

After the project was completed, the Owner refused to pay the GC $6.5 million in contract balance and other disputed work, withholding the money for several reasons, including alleged untimely and defective work on the part of certain subcontractors. The GC then refused to pay the Subcontractor the $1 million balance on the subcontract.

The GC sued the Owner to recover the contract balance owed under the prime contract. The Subcontractor sued the Surety under the payment bond seeking to recover its contract balance under the subcontract. After extensive investigation in the case, the GC concluded that the Owner’s alleged financial problems precluded a reasonable decision by the GC to continue to pursue the full amount of its claim. After making this decision, the GC settled all of its claims against the Owner for approximately $1 million. The GC then offered all of its subcontractors their pro rata share of the settlement. However, the Subcontractor refused to accept the settlement proceeds and continued to pursue its claim against the Surety in District Court.

The Surety denied the Subcontractor’s claim under the payment bond, citing the final payment provision in paragraph 6.f of the subcontract, which conditioned payment to the Subcontractor on the Owner's payment to the GC. Specifically, paragraph 6.f of the parties' subcontract provided, in relevant part:

"Final payment shall be made within thirty (30) days after the last of the following to occur, the occurrence of all of which shall be conditions precedent to such final payment . . . [the Owner] shall have accepted the Work and made final payment thereunder to [the GC] . . . [the GC] shall have received final payment from [the Owner] for [the Subcontractor's] work."

The GC argued that paragraph 6.f constituted a "pay-if-paid" provision. The Subcontractor argued that it constituted a "pay-when-paid" provision. In support of this position, the Subcontractor pointed to the second paragraph of 6.f, which was an "override provision," modifying the "pay-if-paid" clause in the first part of paragraph 6.f to provide that the Subcontractor could make a "claim" against the GC for "any remaining final payment in the event that [the Owner] failed to make final payment within six months."

The Third Circuit found that paragraph 6.f "unequivocally" stated that the Owner’s "payment to [the GC] is a condition precedent to [the GC’s] obligation to pay [the Subcontractor]." In reaching this decision, the Third Circuit cited the following facts: (a) the language of paragraph 6.f was clear; (b) paragraph 6.f delineated seven (7) conditions precedent "to payment, weigh[ing] in favor of a pay-if-paid construction;" and (c) the "override provision" modified the "pay-if-paid" provision to control the timing and extent of the Subcontractor's legal action against the GC in the event of non-payment — meaning, the provision after six (6) months of non-payment by the Owner was converted to a "pay-when-paid" provision, allowing the Subcontra-
tor to sue the GC after six (6) months and after the GC was provided time to recover whatever payment it could from the Owner.

The Third Circuit then considered the meaning of the phrase "any remaining claim for final payment" contained in the "override clause" of paragraph 6.f. In considering the meaning of this phrase, the Court looked to the "Dispute Resolution" paragraph of the Subcontract, which provided a procedural mechanism for pass-through claims. The Dispute Resolution paragraph also contained a "liquidating agreement," whereby the Subcontractor could submit a claim to be passed-up to the Owner. The Subcontractor agreed to be bound to the GC to the extent the Owner made a decision on the Subcontractor’s pass-through claim.

The Court found that its interpretation of the "pay-when-paid" and liquidating agreement paragraphs were consistent with the parties’ intent, at the time of executing the subcontract, to "share the risk of [the Owner’s] non-payment." Thus, the GC did not have to pay the Subcontractor in full because it did not get paid in full by the Owner. Hence, the Subcontractor was bound to the GC’s settlement with the Owner and Subcontractor only could recover its pro rata share of the settlement proceeds. The Court went on to hold that since the GC was not liable to the Subcontractor under the parties’ subcontract, the Surety could not be liable to the Subcontractor on the bond claim, since the Surety “stood in the shoes” of the GC.

What Does this Holding Mean for Contractors? There is little doubt that the Third Circuit and federal district courts will strictly enforce “pay-if-paid” provisions against subcontractors under Pennsylvania law pursuant to the Sloan decision. However, state courts are not required to follow federal law interpreting state law so we will still need to see what happens when a state court must decide if it will follow the Sloan findings. Generally speaking though, state courts tend to follow well-reasoned federal court decisions interpreting state law and it is reasonable to expect that a state court would follow the Sloan decision if the facts were similar. But, only time will tell how the Sloan decision impacts Pennsylvania law and Pennsylvania state courts. Given that Delaware and New Jersey are also in the Third Circuit, the Sloan decision also will be reference to argue the law of payment provisions in those states as well.

There is no doubt that general contractors will find comfort in this ruling and that subcontractors should have serious concerns about the risk they may be accepting in a construction contract. Regardless of where you stand, the Sloan decision does not address or answer other important questions impacting all parties to a construction contract:

(a) What happens if a construction contract contains a “pay-if-paid” provision similar to that in Sloan but the reason for an owner’s non-payment to a general contractor is not because of a subcontractor’s work but rather because of deficient work or delays primarily caused by the general contractor?

(b) In such a case, would a subcontractor still be bound to the "pay-if-paid" provision and any pro rata share of settlement proceeds? In other words, if a general contractor’s actions or inactions are the sole reason for an owner's non-payment, or eventual settlement of an action for considerably less than the full contract balance owed, would a subcontractor still be entitled to pursue a claim against a general contractor and/or owner for its full contract balance?

Unfortunately, at this time, neither contractors nor subcontractors have a clear answer to these questions. Hopefully, a future state or federal court will be able to answer these tough questions and provide additional guidance for the construction industry.

Notwithstanding these unanswered questions, whether you are an owner, general contractor or subcontractor, the lesson to take away from the Sloan decision is to always be mindful of the precise contractual terms of payment provisions when negotiating, drafting and executing construction contracts.

If you are a general contractor, the Sloan decision supports a reasonable belief that state courts likely will follow the Third Circuit’s reasoning. Given that scenario, general contractors would be wise to carefully scrutinize payment provisions contained in their subcontracts and modify their contracts to be consistent with the language in Sloan.

Conversely, if you are a subcontractor, you should recognize that the Sloan decision may impact your ability to collect full payment from a general contractor in certain cases if your subcontract contains similar language to that in Sloan. Before executing subcontracts containing risk-shifting payment provisions similar to those in Sloan, you should consider confirming an owner’s credit-worthiness and valid funding sources. After all, Sloan shifts the risk of an owner’s lack of credit-worthiness to the subcontractor. If you are going to accept the risk of nonpayment, you should understand how big of a risk you are taking in light of an owner’s financial status.

It also is not enough to rely upon the ability to file a mechanic’s lien claim on a project, since a mechanic’s lien only is as valuable as the liened property. Hence, if an owner encounters funding problems, the value of the property may not be sufficient to secure the full amount of the outstanding loan and the amounts owed under your subcontract and that of all the other subcontractors who have not been paid. Therefore, it is imperative that subcontractors make a proactive decision on what risk they are going to accept in executing a particular subcontract.

Most importantly, if you have any doubt as to how payment provisions will impact your company on a particular construction project, you should consult with legal counsel to help you decipher and negotiate your contracts.