

# Pay-If-Paid Clauses: A Powerful Shield From Payment

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Subcontracts typically contain either a pay-when-paid clause or a pay-if-paid (i.e., contingent payment) clause.

A pay-when-paid clause only deals with the **timing** of the obligation to pay the subcontractor. In other words, the general contractor's obligation to pay the subcontractor (or the supplier) is due at some point in time after the the general contractor receives payment from the owner.

A pay-if-paid clause is much different; it makes payment from the owner to the general contractor a **condition precedent** to payment from the general contractor to a subcontractor. That is, if the owner does not pay the general contractor, then the general contractor is not obligated to pay the subcontractor. Although there are no magic words required for a clause to be considered as a pay-if-paid clause rather than a pay-when-paid clause,

courts tend to strictly construe these clauses. Consequently, many pay-if-paid clauses now use the actual words "condition precedent" and make clear that the obligation to pay the subcontractor is absolutely contingent upon the general contractor being paid.



Pay-if-paid clauses are dangerous for subcontractors because these clauses shift the risk of owner non-payment from general contractors to subcontractors. Subcontractors should always try to strike such clauses or revise them to become pay-when-paid clauses.

Subcontractors are rarely in a good position to determine the credit-worthiness of the project owner. In practice, however, subcontractors may lack the leverage to completely negotiate away such clauses. While these clauses are not enforceable in some states, in Texas they **are** enforceable by statute, and they provide the general contractor with an affirmative defense to a claim for payment. Fortunately there are some exceptions and safe harbors that subcontractors in Texas may take advantage of.

## Certain Types of Contracts are Excluded

A pay-if-paid clause is not enforceable if the contract in which it is contained is solely for:

–design services;

–“the construction or maintenance of a road, highway, street, bridge, utility, water supply project, water plant, wastewater plant, water and wastewater distribution or conveyance

facility, wharf, dock, airport runway or taxiway, drainage project, or related type of project associated with civil engineering construction”; or

–improvements to or the construction of a detached single-family residence, duplex, triplex, or quadruplex.

### **General Contractor’s Fault**

A general contractor cannot rely on a pay-if-paid clause to the extent the general contractor is not being paid because the general contractor failed to perform (i.e., failed to properly do its work).

### **Notice**

A subcontractor may object to a pay-if-paid clause being applied to an invoice by waiting 45 days from the date of the invoice and sending a written objection to the general contractor. The notice becomes effective on the latest of a few different deadlines that are based on the Prompt Pay Act and the date the general contractor receives notice. A notice of objection, once effective, precludes the general contractor’s enforcement of a contingent payment clause for labor and materials furnished after the effective date of the notice until the subcontractor is paid. However, the notice exception does not apply if the general contractor gives the subcontractor a timely written notice which states that (1) there is a dispute under the Prompt Pay Act as a result of the subcontractor’s failure to meet its contractual obligations and (2) the subcontractor’s notice to the general contractor will not prevent enforcement of the contingent payment clause.

### **Unconscionability**

A subcontractor may also argue that the clause is “unconscionable.” The subcontractor has the burden to show this exception, which under Texas law is difficult to establish. A pay-if-paid clause is not unconscionable if: (1) the general contractor ascertains and notifies the subcontractor of the owner’s ability to pay for the project; and (2) the general contractor has: (A) made reasonable efforts to collect the amount owed to the subcontractor; or (B) assigned or offered to assign to the subcontractor its cause of action against the owner for the amounts owed to the subcontractor and offered reasonable cooperation to the subcontractor’s collection efforts.

### **Sham Relationship**

In addition, a contingent payment clause is not enforceable if there is a sham relationship between the obligor [typically the owner] and the contingent payor [typically the general contractor].

### **Pay-if-Paid Clause Does Not Waive Lien Rights**

Agreeing to a pay-if-paid clause does not waive lien rights. If you have agreed to a contract with a pay-if-paid clause, it is vital that you enforce your lien or bond rights if you have not been paid. Otherwise, you may be stuck in limbo if the general contractor asserts its rights under the pay-if-paid clause. This serves as another important reminder to not ignore your lien rights.