

# Pay–When–Paid/Pay-If-Paid Contract Clause Comparisons Among South Eastern United States

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The objective of this study was to identify the pay when paid and pay if paid language in construction contracts that best protected payments to a subcontractor for work performed in the South Eastern United States. Data was collected for this study from court cases to analyze court interpretation of the language contained in project contracts. The prime beneficiaries of this study were subcontractors who could use the language suggested in this study to better protect their interests. The results of the study indicated that some states enacted statutes that deemed such clauses unenforceable as a matter of public policy, while others offered no protection to the subcontractor. States considered in the study included Alabama, Georgia, Florida, North Carolina, South Carolina, and Tennessee.

**Keywords:** pay when paid, pay if paid, subcontractor, construction contracts, case law, payment

## Introduction

The process of construction contract payments from the owner to the general contractor and finally to the subcontractors is an integral part of any project. Construction contracts typically include provisions that articulate the payment process. A contract will generally provide that an owner will pay the general contractor upon application of payment being verified and approved by the Architect or the owner's representative. The general contractor will then pay in a timely manner the subcontractors for work properly performed within the scope of their agreements.

Any disruption of the payment process can cause chaos and delay or altogether stop the completion of a project. When owner cannot make payment to the general contractor through no fault of the subcontractor, problems arise. Chief among them, in the eyes of the subcontractor, is the likely dispute between the subcontractor seeking payment and the general contractor who does not want to pay out of pocket that for which he has not been paid.

The question of who bears the burden of risk in these situations has been the subject of numerous papers and court cases. State and federal Courts and legislatures have struggled with this issue. In an effort to resolve disputes, the courts generally interpret the provision in the project contract informally known throughout the industry as the pay when paid and pay if paid provision. The issue with these clauses is whether the contractor has a legal obligation to pay the subcontractor within a reasonable time even though they were not paid, or is payment by owner a condition precedent to payment to the subcontractor, in which case contractor does not have to pay the subcontractor unless payment by owner is first received.

The objective of this study was to identify the pay when paid and pay if paid language in construction contracts that best protected payments to subcontractor from general contractor for work performed in the South Eastern United States. The best language was found by first hypothesizing that no contractual language exists that can ensure payment to a subcontractor who properly performed the scope of work for a general contractor not paid by the owner. The prime beneficiaries of this study were subcontractors doing business in the South Eastern United States who should be aware of the clauses affecting payment for work properly performed within the scope of the contract. Subcontractors could use the language suggested in this study to better protect their interests.

An analysis of the relevant case law and statutes in Alabama, Florida, Georgia, North Carolina, South Carolina and Tennessee was performed to suggest a contract language that can best assure payment to the subcontractor when the owner does not pay the general contractor. The case law researched in each state contained construction contract contingency clauses, timing mechanism clauses, pay when paid and pay if paid clauses.

## **Research Methodology**

Each state's case law and statutes were individually analyzed to determine the majority and minority view. The individual state findings were then collectively compared and contrasted. Statutes pertaining to the enforceability of these clauses were also reviewed. The states' case law and statutes pertaining to the pay when paid and pay if paid clauses comprised the data obtained and used in this research. The paper concentrated on a limited number of south east states in order to provide insight as to the differences among states in relatively close proximity to one another. The study strictly focused on the language that would benefit the subcontractor. The condition precedent language in the clause which determines if and when the subcontractor should be paid by the general contractor not yet paid by owner was specifically analyzed. The most beneficial language for the subcontractor was prepared and an analysis of the potential outcomes in each state jurisdiction offered. The results of the study indicated that some states enacted statutes that deemed pay when paid and pay if paid clauses unenforceable as a matter of public policy, while others offered no protection to the subcontractor.

## **Background**

### *Papers*

Several papers have addressed this issue in some of the states reviewed in this study, but have not collectively compared and contrasted each of the southeastern states for the benefit of the subcontractor. Contingent-Payment Provision Puzzle-Safeguarding Against an Unintended Outcome by Andrea L. May and Kahlid Siddiqi provided insight and analysis of the Florida majority view and the Georgia minority view in deciding pay when paid and pay if paid contract clauses (May & Siddiqi, 2006). The study not only reviewed the language that influenced Court decisions but also the importance placed by the Courts on the intent of the parties.

The "Pay-When-Paid"/"Pay-If-Paid" Dichotomy and the Florida Trilogy-Bright Line or Murky Fog? written by Gerald B. Kirksey and Sherrie L. Brown studied three cases that form the controlling view in Florida (Kirksey & Brown, 1991) The contractors in the three cases, Peacock Construction Co., Inc. v. Modern Air Conditioning, Inc., DEC Electric, Inc. v. Raphael Construction Corp. and OBS Co., Inc. v. Pace Construction Corp., obtained different results. In Peacock the Court found the language to be ambiguous and thus payment should be made to subcontractor (Peacock Construction Co. v. Modern Air Conditioning, Inc.). In DEC Electric, Inc. v. Raphael Construction Corp., the Court found unambiguous language and upheld the nonpayment to the subcontractor (DEC Elec., Inc. v. Raphael Construction Corp.). The Court in OBS Co., Inc. v. Pace Construction Corp., held the language was unambiguous and would have found for the general contractor but for the language of the contract between owner and general contractor stating that general contractor had to pay its subcontractors before payment made by owner (OBS Co., Inc. v. Pace Construction Co.).

"Minimum Decencies"- A Proposed Resolution of the Pay-When-Paid"/"Pay-If-Paid" Dichotomy by Gerald B. Kirksey argued that contingent-payment subcontract agreements are presumptively unconscionable (Kirksey, 1992). These clauses can effectively drive a small to midsize subcontractor into bankruptcy. While it is unlikely that all states will enact legislation such as North Carolina, equitable factors should be considered in the administration of subcontract payment language (Kirksey, 1992).

"Pay-when-paid" Construction Contract Requirement: Bane of the Subcontractor's Existence authored by Howard J. Hollander suggested some solutions to the harsh realities of pay when paid and pay when paid provisions

(Hollander, 2002). Some solutions suggested were legislation to prohibit such clauses and subcontractors seeking more public work in the future where more statutory protections are available.

### *Case Law and Statutes*

#### *Alabama*

Two cases in Alabama provided guidance for the language needed for a favorable finding on behalf of the subcontractor. In *Federal Insurance Co. v. I. Kruger*, the Alabama Supreme Court held that a pay when paid clause in a subcontract which provided that “payment shall be made within thirty (30) days after the last of the following to occur...final payment by Owner to Purchaser on account of the products, including retainage...” was a timing mechanism and not a condition precedent to payment (*Federal Insurance Co. v. I. Kruger, Inc.*). The Court stated that the “mandatory ‘shall’ in conjunction with the verb ‘pay’...creates...an absolute obligation to pay...is reasonably read as merely specifying the time for payment, rather than as creating a condition precedent to payment” (*Federal Insurance*).

The Supreme Court of Alabama in *Lemoine Co. of Alabama, LLC v. HLH Constructors, Inc.* enforced a true contingent payment, or “pay if paid” clause (*Lemoine Co. of Alabama, LLC v. HLH Constructors, Inc.*). The agreement provided that “the obligation to make any payment [to subcontractor]...is subject to the express and absolute condition precedent of payment by [owner]...It is expressly agreed that [contractor]...shall have no obligation to pay...until [contractor] has received payment (*Lemoine*). The clause further stated that subcontractor “expressly assumes the risk of nonpayment” (*Lemoine*).

#### *Florida*

In Florida, the Supreme Court found that contractual language stating that contractor would pay subcontractor “within 30 days after the completion of the work included in this sub-contract, written acceptance by the Architect and full payment therefor by the owner” was an absolute promise to pay and not a condition precedent. (*Peacock Construction Co. v. Modern Air Conditioning, Inc.*). When a contract provides “No funds will be owed to the subcontractor unless the General Contractor is paid by the owner...The subcontractor fully understands that in event of non payment...the subcontractor has legal recourse against the owner through the Mechanics Lien Laws...” an unambiguous condition precedent to payment was formed (*DEC Elec., Inc. v. Raphael Construction Corp., WMS Construction, Inc. v. Palm Springs Mile Associates, Ltd.*). Further, “Final payment shall not become due unless and until the following conditions precedent have been satisfied...(c) receipt of Final Payment for Subcontractor’s work by Contractor from Owner” was also a condition precedent to payment (*OBS Co., Inc. v. Pace Construction Co.*). The Court in *OBS Co. v. Pace Construction Co.* ultimately found in favor of the subcontractor despite the unambiguous language by incorporating by reference the general contract between the owner and general contractor, that required the contractor to pay the subcontractors before the owner paid the general contractor (*OBS Co., Inc. v. Pace Construction Co.*). Florida, like the majority of jurisdictions, will seek to not enforce even unambiguous contingent payment provisions because they find it to be unconscionable.

#### *Georgia*

In Georgia, Courts have upheld the minority view finding the clause “Final payment shall be made within 30 days after the completion of the work included in this sub-contract...and full payment therefor by the Owner...” to be clear and unambiguous language establishing a condition precedent to payment (*Peacock Construction Co. v. A.M. West, St. Paul Fire & Marine Insurance Co. v. Georgia Interstate Electric Co., D.I. Corbett Electric v. Venture Construction Co., Associated Mechanical Corp. v. Martin K. Eby Construction Co.*). Even where a contractor made a payment to a subcontractor without payment from the owner was not enough to waive a pay if paid provision unless clearly and unmistakably stated (*Vratsinas Construction Co. v. Triad Drywall, LLC.*).

*North Carolina*

North Carolina enacted legislation that reads

Performance by a subcontractor in accordance with the provisions of its contract shall entitle it to payment from the party with whom it contracts. Payment by the owner to a contractor is not a condition precedent for payment to a subcontractor and payment by a contractor to a subcontractor is not a condition precedent for payment to any other subcontractor, and an agreement to the contrary is unenforceable (N.C. Gen. Stat. sec. 22C-2).

Therefore, neither pay when paid nor pay if paid clauses are enforceable in the state.

*South Carolina*

The South Carolina “Subcontractors’ and Suppliers’ Payment Protection Act” reads

Notwithstanding any other provision of law, performance by a construction subcontractor in accordance with the provisions of its contract entitles the subcontractor to payment from the party with whom it contracts. The payment by the owner to the contractor or the payment by the contractor to another subcontractor or supplier is not, in either case, a condition precedent for payment to the construction subcontractor. Any agreement to the contrary is unenforceable (S.C. Code Ann. Sec. 29-6-230).

The South Carolina legislature regarded pay when paid and pay if paid clauses unenforceable as a matter of public policy similar to North Carolina. The overriding theme in the two statutes is the inherent unconscionability of placing a subcontractor who performed its job in a position of facing potential bankruptcy by a contractor not willing to pay the subcontractor due its nonpayment by owner.

*Tennessee*

The Supreme Court of Tennessee held that payment from contractor to subcontractor “when and as” payment was received by owner was not a condition precedent (Koch v. Construction Technology, Inc.). A pay when paid and pay if paid clause should include language that “payment from the owner is a condition precedent to any and all payment obligations provided by the contract” (Koch). One opinion by the Court of Appeals contradicts the Koch opinion in finding “no special language is needed to create a condition precedent” (Holland v. Holland). Also, unlike Georgia, a party may waive a condition precedent to payment if it makes payment without the occurrence of the condition precedent (FDIC v. Newton).

**Results & Inferences**

The paper has met its intended purpose by identifying and reviewing the relevant case law and statutes in the identified states and analyzing the contract language pertaining to the pay-when-paid/pay-if-paid clause. Each jurisdiction’s interpretation of similar language was analyzed. A comparison of each state’s interpretation formulated the language deemed most beneficial to the subcontractor.

The majority of states reviewed held that pay when paid and pay if paid clauses were unenforceable, absent clear and unambiguous language stating the condition precedent of payment by owner to contractor before payment to subcontractor. The majority view resolved any ambiguity in favor of the subcontractor. The minority view, followed in Georgia, resolved ambiguity in favor of the contractor. North Carolina and South Carolina have by statute removed the issue from contracts by dictating such language unenforceable as a matter of public policy.

Language such as “payment to subcontractor shall be made within 30 days after completion of work...and full payment by owner” would likely be considered a timing mechanism and would give the contractor a reasonable amount of time to pay, but the obligation to pay is absolute. Alabama, Florida and Tennessee would likely hold in favor of the subcontractor where the above language is included in the contract. Georgia, however, would likely favor the general contractor in this case. North Carolina and South Carolina would reject the language as against public policy and the contractor would have to pay the subcontractor. Table 1 further illustrates the likely outcome of cases where project contracts contain the language detailed above.

Table 1

Contract Language: “Payment to subcontractor shall be made within 30 days after completion of work...and full payment by owner.”

State likely to decide in favor of Subcontractor	State likely to decide in favor of GC
Alabama- -Federal Ins. Co. v. I. Kruger	Georgia- -St. Paul Fire & Marine Ins. Co. v. GA Interstate. Elec.
Florida- -Peacock Const. Co. v. Modern Air Conditioning	-D.I. Corbett Elec. v. Venture Const. Co.
North Carolina- -N.C. Gen. Stat. sec. 22C-2	-Ass. Mechanical Corp. v. Martin K. Eby Const. Co.
South Carolina- -S.C. Code Ann. Sec. 29-6-230	-Vratsinas Const. Co. v. Triad Drywall
Tennessee- -Koch v. Construction Technology	
Note: All cited cases are Supreme Court decisions except GA which includes Supreme Court & Court of Appeals	

Where the contract contains language such as “payment by owner to contractor is a condition precedent and subcontractor expressly assumes the risk of nonpayment,” any court would likely hold in favor of the contractor. A subcontractor should never sign such an agreement unless willing to assume this risk.

### Conclusion

Prior studies on this issue have focused on the contract language that best suited the general contractor and have analyzed a couple of states in the South Eastern United States. This study analyzed the entire region with a focus on subcontractors’ interests. The study reviewed the data from court cases and state statutes pertaining to the pay when paid and pay if paid contract clause to ultimately provide the subcontractor with the best language to protect their interests. The best language for a subcontractor is “contractor shall pay subcontractor within seven days of receipt of payment from owner, but not later than 90 days after receipt of the payment application for work properly performed.” This language affords the contractor a reasonable amount of time to secure payment while providing the subcontractor with protection against absolute nonpayment. Although no case law or statute provides for this specific language, it provides a fair middle ground between non-payment by general contractor until paid by owner and payment within 30 days after completion of work language found in existing case law. By providing a date certain, 90 days, for payment after a payment application has been made, the subcontractor sets a time frame within

which payment should be expected. However, the likelihood of a general contractor agreeing to include this language in a contract is slim.

No contract clause can with absolute certainty guarantee payment from a contractor who has not been paid by an owner to a subcontractor. The inclusion of language favorable to the subcontractor can be difficult during contract negotiations. Contractors, especially in Georgia, will likely seek to include condition precedent language. The language analyzed in this study can provide a framework for some protection. The subcontractor must weigh the risk versus the benefit and recognize that dependent on the jurisdiction, a certain amount of risk exists in all project contracts. The best protection is to work with contractors with a good reputation and review the owner's financial records before agreeing to a contract.

The south east states were the focus of the paper in order to provide insight as to the differences among states in relatively close proximity to each other. A subcontractor doing business in these states can gain an understanding of how these contract provisions have been interpreted in these jurisdictions. The authors have not read any other papers that collectively compare all these states' handling of this contract clause in contracts. The consequence to a subcontractor who does not understand the ramification of this clause as regards their rights to payment can be devastating. Their rights in Georgia are not the same as their rights to payment in North Carolina. A subcontractor that reads this paper should have a good understanding of the laws regarding this contract provision in the south eastern states.

Future research in this area can be performed to include other states besides the southeast to gain a better understanding of the nationwide trend in this area of law. It is highly unlikely that every state will enact legislation removing ambiguity in interpreting this contract language, such as North Carolina and South Carolina. The AIA and other organizations might consider further addressing the issue in a future convention to provide clearer language that could minimize unintended consequences and litigation.

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