



Legal Brief

by Timothy J. Woolford, Esquire

Most “Pay-if-Paid” Clauses Enforceable Under Recent Federal Court Case

Two years ago, I reported in this column about an important court decision by a Philadelphia federal court which, if it was not overturned by a higher court, was likely to affect the enforcement of so called “pay-if-paid” contract clauses.

As most readers of this column know, a pay-if-paid provision in a subcontract usually means that the contractor is not required to pay the subcontractor unless and until the contractor receives payment from the owner. If the owner fails to pay the contractor, the contractor is not required to pay the subcontractor. This is often the most important clause in the entire subcontract. If payment to the general contractor is delayed for any reason, all subcontractors usually endure the pain.

The case I reported on in 2009, *Sloan v. Liberty Mutual Ins. Co.*, involved a claim by a drywall subcontractor for payment against a well-known Philadelphia general contractor, Shoemaker Construction. Shoemaker’s customer, a developer of a high-rise condo building in Philadelphia, went bankrupt before Shoemaker was paid in full. Shoemaker, in turn, did not pay Sloan, its drywall subcontractor in full, pointing to the pay-if-paid clause in the subcontract which provided that receipt of payment from the owner was a condition precedent to Shoemaker’s obligation to pay Sloan.

In the 2009 decision that sent shockwaves through the construction community, the trial court ruled that the pay-if-paid clause

did not defeat the subcontractor’s right to payment. The court reasoned that the law disfavors contract provisions that forfeit important rights, especially rights as important as payment. Consequently, it ruled that the pay-if-paid clause would only be enforced if the language was unmistakably clear that the intent was to shift the risk of the owner’s failure to pay to the subcontractor. The clause in the subcontract in question was not clear enough, in the court’s view, and the court declined to enforce it. In response to this decision, many general contractors (and subcontractors who hire subcontractors) updated the payment provisions in their subcontracts to add the type of language that the trial court indicated was required to shift the risk of the owner’s non payment to the subcontractor.

The trial court’s ruling was appealed and recently, the Third Circuit Court of Appeals (only one step removed from the U.S. Supreme Court) overturned the decision and ruled that the pay-if-paid clause was enforceable as written and defeated the subcontractor’s claim for payment. It interpreted the clause to find that the payment to Shoemaker by the owner was a condition precedent to Shoemaker’s duty to pay Sloan. Unlike the lower court in 2009, the Court of Appeals determined that the language was sufficiently clear to transfer the risk of the owner’s non-payment to the subcontractor. It looked to other parts of the subcontract that it felt were consistent with its interpretation, including the dispute resolution provisions which indicated that Shoemaker and Sloan “intended to share

the risk of the owner’s non payment.”

The decision of the Third Circuit Court of Appeals is binding on all federal courts in Pennsylvania. It is not binding, however, on Pennsylvania state courts. Thus, if you have a case in Cumberland County Court, for example, that court is not bound by the federal court’s ruling. However, state court judges often find federal court decisions persuasive, especially those from such a high court.

Thus, it is very likely that a state court or arbitrator interpreting a pay-if-paid clause would enforce the pay-if-paid clause. The federal court decision is also consistent with the most recent Pennsylvania state court decision on pay if paid clauses, which was handed down over 20 years ago, making it all the more likely that a pay-if-paid clause will be enforced.

The decision is good news for general contractors and others who issue contracts with pay-if-paid language because it makes it virtually certain that pay-if-paid clauses will be enforced and upheld. For subcontractors, this decision makes it all the more critical to carefully review the subcontract before signing it so you can determine whether your right to payment is conditioned upon the general contractor’s receipt of payment from the owner.

If so, you must find out as much as you can about the owner’s financial condition since you are essentially risking the company’s financial success on the owner’s creditworthiness.