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HWH Legal Alert

USING MAGIC WORDS: UNDERSTANDING *PAY-IF-PAID VS. PAY-WHEN-PAID* CLAUSES IN CONSTRUCTION AGREEMENTS

There are countless ways for a construction project to go awry. The first claims that come to mind are those based on delays or defective workmanship, but perhaps even more common are the potential claims which arise when a general contractor does not receive payment from the owner, but remains potentially liable to its subcontractors for work performed. Like most construction disputes, the answer to the question of whether or when a general contractor is liable for payment to its subcontractors starts (and often ends) with the language of the contract.

Beal Bank Nevada v. Northshore Center THC, 64 N.E.3d. 201, 407 Ill. Dec. 823 (1st Dist. 2016) is a recent case from the Appellate Court of Illinois (First District) discussing this issue, and providing guidance to understanding payment risks in a construction agreement in the context of *pay-when-paid* vs. *pay-if-paid* clauses.

The facts of the *Northshore Center* are simple. Northshore Center THC, LLC ("Owner") borrowed funds from BankFirst to develop real estate in Northbrook, Illinois. The Owner entered into an agreement with a general contractor, FCL Investors, Inc. ("General Contractor"), to perform certain construction work at the Northbrook site. The General Contractor then entered into a subcontract with Lake County Grading Company, LLC ("Subcontractor") to provide excavation work, sewer line installation, and other construction services. The Subcontractor performed its work and issued several invoices to the General Contractor which the General Contractor submitted to the Owner. The Owner failed to pay the General Contractor, who in turn didn't pay the Subcontractor.

When the parties were unable to resolve their differences, a lawsuit ensued. The main issue between the General Contractor and the Subcontractor concerned whether the subcontract required the General Contractor to pay the Subcontractor's invoices even though it was undisputed that the Owner had not yet paid the General Contractor. The relevant portions of payment clause in the subcontract provided that:

> The Contractor will make partial payments to the Subcontractor in an amount equal to 90 percent of the estimated value of work and materials incorporated in the construction and an amount equal to 90 percent of the materials delivered to and suitably and properly stored by the Subcontractor at the Project site, to the extent of Subcontractor's interest in the amounts allowed thereon and paid to Contractor by the Owner, less the aggregate of previous payments, within five (5) days of receipt thereof from the Owner.

The trial court reviewed this payment clause and ruled that payment by the Owner was a condition precedent to the General Contractor's obligation to pay its Subcontractor:

> [T]he provisions outlined in the subcontract at issue clearly make the receipt of payment from the Owner to [the General Contractor] the condition precedent to the [Subcontractor's] payment. The condition precedent has not been satisfied as [the General Contractor] has not received payment from Owner.

Therefore, because the Owner had not paid the General Contractor, the trial court determined that the General Contractor could not have breached the subcontract by failing to pay the Subcontractor.

The Subcontractor appealed. The Appellate Court reversed the trial court and found that the payment clause in the subcontract did not contain a condition precedent requiring the General Contractor to be first paid by Owner. Instead, the Appellate Court ruled that the payment clause in the subcontract governed only the amount and timing of payments, not the threshold obligation of the General Contractor to compensate the Subcontractor (even if the General Contractor had not been paid by the Owner).

In so holding, The Appellate Court applied the following "useful framework" for distinguishing between *pay-if-paid* clauses and *pay-when-paid* clauses in construction agreements:

> A *pay-when-paid* clause governs the timing of a contractor's payment obligation to the subcontractor, usually by indicating that the subcontractor will be paid within some fixed time period after the contractor itself is paid by the property owner. . . . In contrast, a *pay-if-paid* clause provides that the subcontractor will be paid *only if* the contractor is paid and thus ensures that each contracting party bears the risk of loss only for its own work.

Applying that framework, the Appellate Court determined that the contractual provision in the subcontract was a *pay-when-paid* clause, which governed only the timing of payment, and not a *pay-if-paid* clause, which would have governed the General Contractor's obligation to pay. In other words, in this case, the Court concluded that there was no condition precedent to payment; the General Contractor had to pay the Subcontractor whether or not the Owner had paid.

Lessons Learned

Northshore Center is an illustrative case study on the importance of payment provisions in construction agreements being drafted so that they are particularly clear and unambiguous with respect to their *pay-if-paid* intentions. In our experience, many subcontract agreements in Illinois have payment provisions that do not sufficiently identify that payment by the owner is a condition precedent. As demonstrated by *Northshore Center*, even language as clear as "to the extent" is inadequate. Without the "magic word", *i.e.* "if", that makes it clear that the general contractor's payment obligation to its subcontractor exists only "if" payment is made by the owner to the general contractor, the general contractor will likely bear the risk of payment even where the owner doesn't pay the general contractor. The first and best protection against such unnecessary payment risk is a well-written contract. *Pay-if-paid* clauses offer greater protection to general contractors and should be a consideration on all sides during the drafting process.

Contacts

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Information

A copy of Beal Bank Nevada v. Northshore Center THC, 64 N.E.3d 201, 407 Ill. Dec. 823 (1st Dist. 2016) is available here.