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## **Ohio Supreme Court Enforces Pay-if-Paid Provision: Shifts Risk of Project Owner's Nonpayment Onto the Subcontractor**

When a project owner fails to pay the prime contractor, is the contractor still on the hook to pay its subcontractor?

Generally, the risk of an owner's nonpayment falls on the prime contractor. That is, if the owner becomes insolvent or just refuses to pay, the prime must still pay its subcontractor after a reasonable period of time. This is true even if the subcontract contains language such as: "Contractor shall pay subcontractor within seven days of contractor's receipt of payment from the owner." These are referred to as "Pay-**When**-Paid" provisions, and the owner's nonpayment does not excuse the prime's obligation to the subcontractor.

### **But, can a prime contractor shift the risk of an owner's nonpayment to the subcontractor?**

A "Pay-**If**-Paid" provision shifts the risk of the owner's nonpayment to the subcontractor. If the subcontract contains a valid Pay-If-Paid provision, the subcontractor will not be paid for work performed unless the project owner first pays the prime contractor. If the owner becomes insolvent, the prime has no obligation to pay its subcontractor. The subcontractor also may not receive payment when the owner fails to pay the prime based on a dispute over delay or even when the owner gives no reason for its refusal to pay.

When these issues have arisen in the past, the battle has been over whether the language in the subcontract forms a Pay-When-Paid or a Pay-If-Paid provision. The trend among Ohio courts had been to interpret the language in subcontracts to only include Pay-When-Paid provisions. It became questionable whether Ohio courts would recognize *any* language as creating a valid Pay-If-Paid provision.

The Ohio Supreme Court answered that question on July 17, 2014 in the case of *Transtar Elec., Inc. v. A.E.M. Elec. Servs. Corp.*, 2014-Ohio-3095. In *Transtar*, an electrical subcontractor filed suit against the prime contractor for nonpayment. The subcontractor worked on a pool installation project at a Holiday Inn. The subcontractor fully performed its contract, but the prime did not pay the subcontractor's last few invoices. The reason? The owner had not paid the prime for this work.

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The subcontract contained the following language:

**RECEIPT OF PAYMENT BY CONTRACTOR FROM THE OWNER FOR WORK PERFORMED BY  
SUBCONTRACTOR IS A CONDITION PRECEDENT TO PAYMENT BY CONTRACTOR TO  
SUBCONTRACTOR FOR THAT WORK.**

The Sixth District Court of Appeals found that that this language was not sufficient to create a valid Pay-If-Paid provision. The Ohio Supreme Court disagreed. The Court held that the subcontract's use of the term "condition precedent" was an "explicit statement of the parties' intent to transfer the risk of the project owner's nonpayment" to the subcontractor.

When this "condition precedent" language is used in the subcontract, the prime has no obligation to pay its subcontractor unless the project owner first pays the prime. Going forward, courts following the Ohio Supreme Court's decision in *Transtar* will enforce Pay-If-Paid provisions.

Therefore, subcontractors must determine whether their subcontract contains a Pay-When-Paid provision or a Pay-If-Paid provision. If it is a Pay-If-Paid provision, the subcontractor is accepting the risk of a project owner's nonpayment (due to insolvency or other grounds). This presents some practical difficulties for subcontractors since they often have little ability to evaluate, monitor or control that risk on a project. Also, the prime contractor will have less incentive to pursue the project owner for payment owing to the subcontractor. The subcontractor lacks the privity of contract with the owner to pursue most claims against the owner directly.

Therefore, it is important that subcontractors understand the risks when entering contracts with Pay-If-Paid provisions. Also, subcontractors should protect their mechanic's lien rights as Pay-If-Paid provisions do not prevent the subcontractor from filing a mechanic's lien.

If you have any questions concerning this client alert, contact Attorney Owen J. Rarric at orarric@kwgd.com at 330-497-0700.

*NOTE: This general summary of the law should not be used to solve individual problems since slight changes in the fact situation may require a material variance in the applicable legal advice.*