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Subcontractor's Right to Payment

Paid-if-paid and pay-when-paid clauses under the New Jersey Construction Lien Law

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General contractors sometimes include in their subcontracts clauses which condition payment from the general contractor to the subcontractor on payment from the owner to the general contractor. These clauses, depending on their language, are commonly known as "pay-if-paid" or "pay-when-paid" clauses. A pay-if-paid clause requires payment to the subcontractor *only if* the general contractor is paid by the project owner. A typical pay-if-paid clause might read: "Contractor's receipt of payment from Owner is a condition precedent to

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Contractor's obligation to make payment to Subcontractor. Subcontractor expressly assumes the risk of Owner's nonpayment and the subcontract price includes such risk."

A pay-when-paid clause requires payment to the subcontractor *when* the general contractor gets paid. A typical pay-when-paid clause might read: "Contractor shall pay Subcontractor within seven days of Contractor's receipt of payment from Owner." This article is limited to the continued enforceability of pay-if-paid and pay-when-paid clauses in subcontracts on private construction jobs in New Jersey. Pay-if-paid and pay-when-paid clauses in subcontracts on public construction jobs are beyond the scope of this article.

Unlike some other states, New Jersey has no statute specifically governing the enforceability of pay-if-paid and pay-when-paid clauses. The only reported court decision discussing the enforceability of either of these clauses under New Jersey law is a 1984 federal District of New Jersey case, *Seal Tite Corp. v. Ehret, Inc.*, 589 F. Supp. 701 (D.N.J. 1984), which relied heavily on a 1962 Sixth Circuit decision interpreting Ohio law, *Thos. J. Dyer Co. v. Bishop International Engineering Co.*, 303 F.2d 655 (6th Cir. 1962). Both *Seal Tite*

and *Thos. J. Dyer* dealt with subcontracts containing pay-when-paid clauses, which provided for payment to the subcontractor within a certain number of days after payment is made by the owner to the general contractor. In each case, the owner had become insolvent and the general contractor claimed that it was not obligated to pay the subcontractor because the general contractor had not been paid by the owner. Both courts held that the issue was one of contract construction, and not of public policy, and agreed with the subcontractor that the pay-when-paid clause did not reflect the intention of the parties to shift the risk of the owner's insolvency from the general contractor to the subcontractor. The courts interpreted these standard pay-when-paid clauses, not as creating an absolute condition precedent to payment to the subcontractor, but rather as affording the general contractor a postponement of payment for a reasonable period of time to allow the general contractor an opportunity to collect funds due from the owner.

The *Seal Tite* and *Thos. J. Dyer* decisions also suggested that the parties to a subcontract could shift the risk of the owner's insolvency to the subcontractor, and make payment to the general contractor an absolute condition

precedent to payment to the subcontractor, provided that the subcontract clearly and unequivocally so provides. As a result, many New Jersey attorneys and their contractor clients have operated under the assumption that, properly drafted, pay-if-paid clauses are enforceable in New Jersey, even though no reported court decision has ruled on the enforceability of a true pay-if-paid clause under New Jersey law.

It is important to reiterate that *Seal Tite* and *Thos. J. Dyer* were not decided on public policy grounds, and to note that at the time of those decisions there was no express public policy, in either New Jersey or Ohio, as codified by statute or otherwise, against the enforceability of pay-if-paid clauses. This state of affairs clearly changed in New Jersey in 1994 with the enactment of the New Jersey Construction Lien Law (CLL), N.J.S.A. 2A:44A-1, et seq. The CLL allows a subcontractor to place a lien on privately owned real estate on which it has performed work to secure payment for that work. Unlike New Jersey's prior Mechanics' Lien Law, the CLL provides that "[w]aivers of construction lien rights are against public policy, unlawful, and void," except to the extent of payments actually made to the subcontractor. N.J.S.A. 2A:44A-33. The highest courts of two other states, New York and California, which similarly prohibit lien waivers by statute, have invalidated pay-if-paid clauses in subcontracts as against public policy. See *West-Fair Electric Contractors v. Aetna Cas. & Sur. Co.*, 661 N.E.2d 967 (N.Y. 1995), and *Wm. R. Clarke Corp. v. Safeco Ins. Co. of America*, 938 P.2d 372 (Cal. 1997). *West-Fair* and *Wm. R. Clarke Corp.* held that a pay-if-paid clause, by shifting the risk of the owner's nonpayment to the subcontractor, is essentially an illegal lien waiver and void against public policy, because a lien claim may not be enforced until payment is actually due and owing, which may never occur under such a clause.

While one might conclude, based on the CLL and the reasoning of the *West-Fair* and *Wm. R. Clark Corp.* decisions,

that pay-if-paid clauses will not be enforced in New Jersey, an unreported New Jersey Appellate Division decision, *Avon Brothers, Inc. v. Tom Martin Construction Co., Inc.*, 2000 WL 34241102 (App. Div. 2000), has muddied the waters a bit. In that case, the plaintiff-subcontractor argued, among other things, that, consistent with the *West-Fair* and *Wm. R. Clarke Corp.* decisions, clauses which purport to shift the collection risk to the subcontractor should be deemed unenforceable as against public policy. The subcontractor's argument was premised on the payment clause at issue being a pay-if-paid clause. The court correctly held, however, that the payment clause at issue was actually a pay-when-paid clause and distinguished *West-Fair* and *Wm. R. Clarke Corp.*, which involved pay-if-paid clauses.

The Appellate Division further held, relying on *Seal Tite* and numerous extra-jurisdictional cases, that such pay-when-paid clause did not act as an absolute condition precedent to payment but only to postpone payment for a reasonable time period. The period in *Avon Brothers* had long since passed. In dictum, however, the court, after distinguishing *West-Fair* and *Wm. R. Clarke Corp.* as pay-if-paid cases, stated: "We note, however, that the New Jersey Supreme Court has recently rejected an overly technical interpretation of the 'due and owing' requirement for filing a lien claim, thereby calling into question the underlying premise of the New York and California decisions. See *Thomas Group v. Wharton Sr. Housing*, 163 N.J. 507 (2000)."

The Appellate Division's reliance on *Thomas Group* for this conclusion is misplaced. In *Thomas Group*, the Supreme Court addressed the interplay between the CLL and retainage clauses in construction contracts. N.J.S.A. 2A:44A-6 requires that a contractor file a lien claim not later than 90 days following the date the last work was provided. N.J.S.A. 2A:44A-8 requires that the contractor represent and verify that the amount claimed is "due and owing." N.J.S.A. 2A:44A-14 requires that the

contractor file suit to establish the lien claim within one year of the date of the last provision of work. In *Thomas Group*, a general contractor filed a lien claim within the 90-day limitation period, and also filed suit within the one year limitation period, but did not fully comply with the contract provisions for release of the retainage, including completion of punch list items and other technical requirements. Arguably, the amount claimed was not "due and owing" because the contractual conditions had not been satisfied, even though the amount claimed approximated the value of the work performed.

The Supreme Court held that, in order to further the remedial purpose of the CLL, the contractor's lien claim should not have been discharged by the trial court, and the trial court should have stayed the contractor's foreclosure proceeding pending determination of the amount due pursuant to arbitration under the contract. The Court advised that, "in the future the interests of an owner can adequately be protected by staying the contractor's right to enforce its lien until the contractual preconditions of payment are met," and that "the trial court should fix a reasonable schedule for the contractor to complete the preconditions of payment."

In *Thomas Group*, the Supreme Court fashioned a remedy, under the facts and circumstances of that case, to permit a contractor to file a lien claim, and ultimately enforce that lien claim, even though the contractor may not have been able to satisfy the conditions for release of the retainage in accordance with the contract within the limitation periods of the CLL (assuming the contractor does satisfy such conditions in accordance with a reasonable schedule to be fixed by the court). *Thomas Group* is consistent with the underlying premise of *West-Fair* and *Wm. R. Clarke Corp.* in interpreting a remedial statute in a manner consistent with the public policy of permitting contractors to file and enforce lien claims to protect the value of the work they have created. *Thomas Group* did not involve a pay-if-paid clause,

which, by its terms, would prevent a subcontractor from ever satisfying the preconditions of payment in the event of the insolvency of the owner.

Accordingly, and notwithstanding the dictum in *Avon Brothers*, it is likely that a pay-if-paid clause, which clearly shifts the risk of the owner's nonpay-

ment to the subcontractor, will be deemed unenforceable as against public policy in New Jersey, consistent with *West Fair* and *Wm. R. Clarke Corp.* Pay-when-paid clauses, however, will likely remain enforceable. Unlike a pay-if-paid clause, where the obligation to pay the subcontractor may never

ripen, a pay-when-paid clause, as interpreted by *Seal Tite*, *Thos J. Dyer* and *Avon Brothers*, will only delay payment to the subcontractor for a reasonable time. The payment obligation will, therefore, ultimately ripen, permitting the subcontractor to file and enforce a lien claim. ■