

SUBCONTRACTORS MAY BE EXPOSED TO THE RISK OF NONPAYMENT DUE TO A CONTINGENT PAYMENT CLAUSE, EVEN IF THERE IS A PAYMENT BOND IN PLACE...



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cannot make payment, which may be because the general contractor was not paid by the owner.

Subcontractors are often in the difficult position of having to decide whether to enter into subcontracts containing "contingent payment" clauses, specifying that the subcontractor is not entitled to payment until the general contractor has been paid by the project owner. When properly crafted, contingent payment clauses serve to shift the risk of an owner's nonpayment away from the general contractor and on to the subcontractor--a risk that many subcontractors are not suited to bear. Often, a subcontractor is not in a position to be able to handicap the chances of an owner's nonpayment before agreeing to take on a project.

Accordingly, subcontractors face a significant decision when asked to sign a contract containing such a provision. Some subcontractors may feel that their risk is mitigated if there is a payment bond in place for the benefit of those supplying labor and materials to the project. After all, the purpose of a payment bond is to assure payment to subcontractors and suppliers in the event the general contractor

However, any such sense of security is likely to be misplaced, as sureties have denied claims on the basis of contingent payment clauses appearing in subcontracts. That is, the payment bond surety may seek to use the contingent payment clause appearing in the subcontract as a way to deny payment to the subcontractor, even though the purpose of a payment bond is to ensure payment to subcontractors/suppliers when the contractor or owner cannot do so.

While sureties are typically permitted to assert whatever defenses to payment that are available to the general contractor, the use of a contingent payment subcontract clause as a defense to a payment bond claim raises an important policy concern because a payment bond is often considered to be a safety-net for subcontractors and suppliers. Several courts that have looked at the issue (still a relatively small number) have expressed concern that allowing a surety to assert a defense based on a contingent payment clause could leave the unpaid subcontractor without a source of recovery. Some courts that have looked at the issue have rejected the use

of such a defense by sureties altogether, concerned that allowing sureties to rely on pay-if-paid clauses would serve to defeat the purpose of the payment bond, i.e., a source of recovery where the general contractor cannot make payment. Other courts have read such clauses with great scrutiny, sometimes finding them not to be "contingent payment" clauses at all, but instead mere "timing mechanisms" for payment.

Although the question is still open in much of the country, a trend does appear to be forming against allowing sureties to assert such defenses. However, because the question has not been conclusively answered in most jurisdictions, subcontractors should be sure to consult with their attorneys about the state of the law in their jurisdiction before accepting a subcontract with a contingent payment clause, even if the project is bonded.

