The Effect of "Pay-if-Paid" Clause Has Been Eroded In Maryland

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Many construction contracts contain what is known as the "pay-if-paid" clause. These clauses make payment by the owner to the general contractor, a condition precedent to the general contractor's obligation to pay its subcontractor. The desired effect of the "pay-if-paid" clause is to shift to the subcontractor the risk that the owner will not pay for the work. Since the 1991 case of Gilbane v. Brisk Waterproofing, Maryland courts have held the onerous "pay-if-paid" clause to be valid and enforceable. However, both general contractors and subcontractors should be aware that on many types of projects in Maryland, the "pay-if-paid" clause is effectively neutralized.

Private Projects Subject to a Mechanic's Lien

The Maryland Mechanic's Lien Statute specifically provides in 9-113 that "[a] provision in an executory contract between a contractor and a subcontractor . . . that conditions payments to the subcontractor on receipt by the contractor of payment from the owner or any other third party may not abrogate or waive the right of the subcontractor to . . . [c]laim a mechanics' lien or . . . sue on a contractor's bond." The Maryland Legislature has deemed such a provision to be "void as against the public policy of the State." Thus, while the "pay-if-paid" clause strips the subcontractor of the right to sue the general contractor for nonpayment, this mechanic's lien statute nevertheless enables the subcontractor to pursue a mechanic's lien against the owner and/or a payment bond claim against the general contractor's surety. In other words, neither the owner nor the surety may rely upon the "pay-if-paid" clause to avoid liability on a private project in Maryland which is subject to a mechanics' lien.

State and Local Government Projects

Pursuant to a recent legislative amendment to Maryland's Little Miller Act, a similar protection is now afforded subcontractors working in public projects in Maryland. Public projects are not subject to mechanic's liens, and so instead, Maryland's Little Miller Act requires the general contractor to post a payment bond on certain state and local government construction projects. Section 17-108 of this Act was amended in 2000 to provide that "[a] provision in an executory contract between a supplier and a contractor or subcontractor . . . that conditions payment to the supplier on receipt of payment . . . from a public body or third party, may not abrogate or waive the right of the supplier to sue [on the contractor's payment bond]." Again, while the "pay-if-paid" clause strips the subcontractor of the right to sue the general contractor for nonpayment, the subcontractor may still recover by bringing a payment bond claim against the general contractor's surety on a public project in Maryland. The surety may not rely upon the "pay-if-paid" clause as a defense.
Federal Projects

The Federal Miller Act requires the general contractor to post a payment bond on certain federal construction projects. In a very recent federal case, Walton Technology v. Weststar Engineering, the subcontractor sued the general contractor and its Miller Act surety to recover unpaid equipment rental fees on a federal project in Washington. The general contractor had not been paid by the federal government, and so, the general contractor and its surety raised the subcontract's "pay-if-paid" clause as a defense. The Federal Appeals Court, however, ruled that the surety was liable to the subcontractor despite the "pay-if-paid" clause. The court concluded that, while a subcontractor can waive its Miller Act rights by making a "clear and explicit" waiver, a "pay-if-paid" clause does not constitute such a clear and explicit waiver. Thus, the subcontractor was permitted to recover against the payment bond on this federal project.

The Prevention Doctrine

Another line of cases holds that the "pay-if-paid" clause may become unenforceable under the prevention doctrine. The prevention doctrine essentially provides that a contract condition will not be enforced if the party seeking to benefit from the condition undertakes actions that prevent or hinder the occurrence of the condition. For example, the general contractor may not rely upon the pay-if-paid clause to avoid paying retention to a subcontractor, where the owner is withholding retention solely because the general contractor has refused to perform punch list work or to submit project close-out documents. In other words, the general contractor may not enforce the "pay-if-paid" clause where the general contractor is at fault in causing the owner to withhold payment.

Conclusion

Thus, in Maryland, there remain very few construction projects on which the "pay-if-paid" clause will completely prevent a subcontractor from getting paid, even though the general contractor has not been paid.